

Australian Equities Income Portfolio

Performance Report – July 2022

Market overview and portfolio performance



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The S&P/ASX 200 Industrials Accumulation Index was up 8.16% during the period.

Information Technology (+15.2%) was the best performing sector, with key constituents Xero (XRO +20.8%) and WiseTech Global (WTC +32.4%) benefitting from the impact of falling bond rates during the month. REITs (11.9%) also outperformed, similarly benefitting from falling bond rates and the positive implications for property valuations. Utilities (+3.1%) was the worst performing sector in a strong market, posting respectable gains. Key constituents APA (APA +3.4%) and Origin Energy (ORG +3.7%) were impacted by a falling oil price during the period. Industrials (+3.5%) also underperformed, with a “risk-on” move seeing defensive companies such as Transurban Group (TCL +0.9%) lagging.

The DNR Capital Australian Equities Income Portfolio underperformed the Index for the month. Key stock contributors were Transurban Group (TCL, No Holding), Super Retail Group (SUL) and Lendlease (LLC). Key stock detractors were BHP Group (BHP), QBE Insurance Group (QBE) and SKYCITY Entertainment Group (SKC).

Portfolio overview

Investment bias	Style neutral
Designed for	Investors who seek a greater level of income and who can make use of franking credits
Benchmark	S&P/ASX 200 Industrials Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Industrials Accumulation Index and deliver higher levels of income (before fees) over a rolling three year period
Investable universe	ASX listed securities with a focus on S&P/ASX 200 and ASX listed convertible securities
Number of stocks	15–30
Asset allocation	Australian equities 80–100% Cash 0–20%
Stock limit	15% maximum weighting
Minimum suggested investment timeframe	5 years

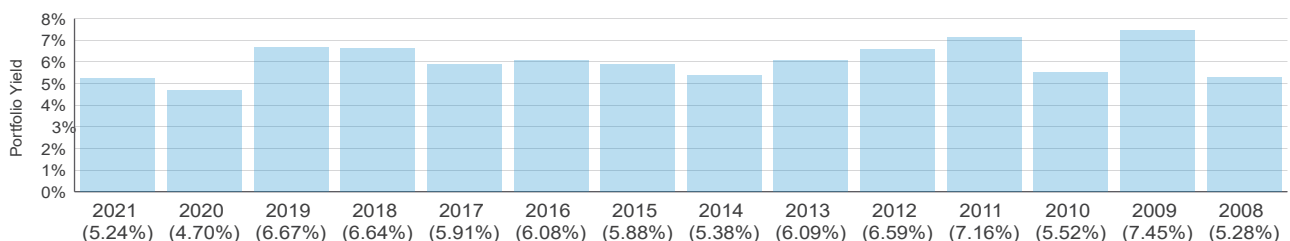
The Portfolio's dividend yield expectation for 2022 is currently 4.3% (5.8% grossed up for franking credits).

Gross active return

	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Income Portfolio	4.53	-2.60	5.86	7.30	9.90	9.67	8.81	12.93	8.22
S&P/ASX 200 Industrials Accumulation Index	8.16	-4.27	2.40	-1.48	3.71	6.75	6.04	10.06	5.62
Excess Return	-3.63	1.67	3.46	8.78	6.19	2.92	2.77	2.87	2.60

* Inception date—December 2007

Grossed-up yield (calendar year)*



*Gross yield calculation uses income (including franking credits) ex-date and applies a monthly capital rebasing over the 12 month period (January to December).

Source: DNR Capital

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.

Market review

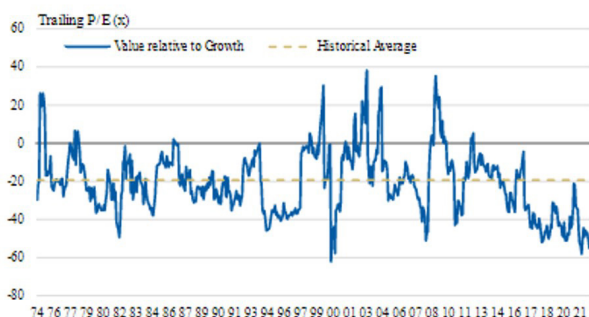
Global equities rebounded in July as global GDP contracted, softening investor expectations of future rate hikes. Growing recessionary risks, means we are potentially closer to the end of the interest rate rising cycle, at least that is what the market thinks. Bond yields tumbled as a result.

Australia underperformed global equities. The Income portfolio underperformed during the month as defensives were used as funding and materials and energy underperformed.

Growth and duration stocks bounced, with expectations of a slowing economy lowering bond yields and supporting valuations. We appreciate the justification for the market gravitating to higher quality growth companies, but we have also observed lower quality, speculative names rallying sharply. Our experience suggests the bear market ends when capital exits these lower quality businesses.

Of particular interest, the discount for value stocks PE multiples is almost back at all-time highs.

Australia value vs. growth trailing price to earnings

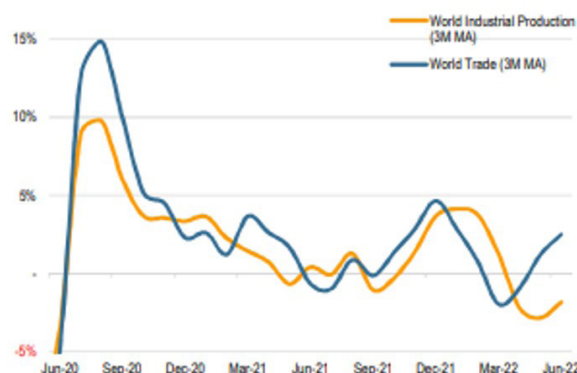


Source: RIMES, MSCI, Morgan Stanley Research

Global data weakens

Global output fell 1.6% in the June 2022 quarter after a 6.7% gain in the March 2022 quarter. Manufacturing output in China collapsed due to COVID-19 related lockdowns, consumer spending on goods has been subdued and business spending has also softened. In addition, consumer and business sentiment has declined and now looks likely to weigh on demand.

Global trade vs. industrial production (3M MA)



Source: J.P. Morgan calculations, Bloomberg Finance L.P.

Reporting season mixed messages

Australian companies will report results over the coming weeks. We expect the strong trends evident in February to have continued through 2H22. While investors will be encouraged by solid FY22 numbers, the greatest focus will be on outlook statements. However, given the high degree of macro uncertainty (inflation, recession, geopolitical tensions), management teams may be reluctant to provide meaningful outlook commentary.

Key reporting season focus areas:

- 1. Supply chain constraints and inventory levels:** Supply chain constraints have negatively impacted operations for most of this year, however, there are signs that bottlenecks are beginning to open. Excessive inventory build is also a potential concern as companies stocked up in anticipation of robust consumer spending.
- 2. Labour shortages:** COVID-19 disruption (absenteeism) and low unemployment have created difficulties in finding labour and may have already started to negative impact on productivity and operating costs.
- 3. Input cost pressures and profit margins:** Similarly, broad input cost pressures from rising inflation may have started to negatively impact operations.
- 4. Cost of debt:** The impact of the rising cost of debt may have a negative impact on the net interest outlook for some companies, particularly those with significant and unhedged debt balances.
- 5. Slowing demand:** So far signals have been mixed, with consumers continuing to spend, although surveys point to a deterioration ahead.
- 6. Earnings outlook:** For FY23, the consensus is projecting growth of greater than 4% for the ASX200, with ex-materials growth expectations in excess of 14% driven by financials and industrials. We believe there is earnings downside risk.

Dividend outlook

A record \$47 billion in dividends has been declared or paid so far this year and we expect dividends to be substantially higher again during the forthcoming reporting season. This will be largely driven by the big miners and energy companies.

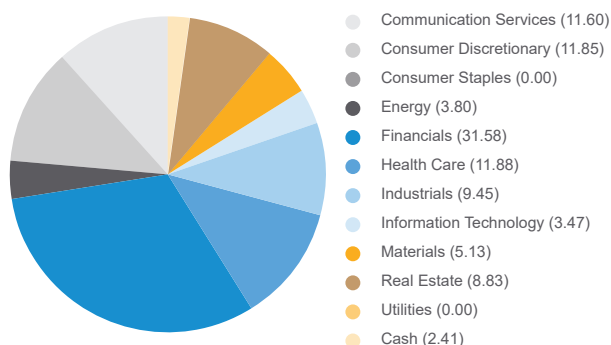
These stocks are expected to account for over one third of the dollar dividends generated by the market for 2022, whilst the big 4 banks will generate about 20%. This means well over half of 2022 dollar dividends are essentially coming from just a handful of stocks. Or put another way, the rest of the market, comprised mainly of industrial companies, is currently generating average yields of just ~3% pa.

Macro uncertainty means companies will adopt a more conservative position on capital management. New buybacks and dividend increases are unlikely. Beyond FY22, dividends will payout earnings, which are likely to be 5-10% lower in FY23, driven primarily by lower dividends in the mining sector.

Nonetheless, over the next 12 months, the market is forecasting gross yields of ~6%. This is still very attractive compared to alternatives, despite the recent surge in interest rate expectations, particularly with the outlook for inflation and real rates. Australia is well positioned relative to global markets too. The yield differential between the two is currently at a record high, with global developed market dividend yields at just ~2%.

Portfolio attribution

Sector weightings %



Source: DNR Capital

Attribution

The top stock contributors for the month were:

- **Transurban Group (TCL, No Holding):** defensives underperformed during the month as investor expectations of future rate hikes softened and markets rallied.
- **Super Retail Group (SUL):** outperformed the market on no company specific news but in line with broader consumer discretionary stocks. Rate hikes and inflation concerns have weighed on consumer stocks. Retail sales remain robust but risks remain for FY23.
- **Lendlease (LLC):** rallied during the month after a period of underperformance. 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.

The top stock detractors for the month were:

- **BHP Group (BHP):** underperformed over the month as spot iron ore prices softened on concerns of slowing global growth. While rising interest rates will weigh on economic growth, China is making more indications that it plans to shift towards more commodity intense fiscal stimulus which should help support demand.
- **QBE Insurance Group (QBE):** bond yields pulling back likely caused sentiment towards QBE to soften but there was no specific news impacting the company.
- **SKYCITY Entertainment Group (SKC):** fell over the month as rising rates stoked fears of a softer New Zealand consumer impacting visitation. The business continues to rebound after extended COVID-19 lockdowns and is trading below long term valuation metrics

Monthly - top contributors and detractors

Top 3 contributors		Alpha*
Transurban Group	No Holding	0.22%
Super Retail Group	Overweight	0.16%
Lendlease	Overweight	0.15%

Top 3 detractors		Alpha*
BHP Group	Overweight	-0.57%
QBE Insurance Group	Overweight	-0.45%
SKYCITY Entertainment Group	Overweight	-0.43%

12 month - top contributors and detractors

Top 3 contributors		Alpha*
National Australia Bank	Overweight	0.92%
Tabcorp Holdings	Overweight	0.80%
Macquarie Group	Overweight	0.65%

Top 3 detractors		Alpha*
Commonwealth Bank of Australia	No Holding	-0.72%
SKYCITY Entertainment Group	Overweight	-0.50%
Lendlease	Overweight	-0.49%

* 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.

Portfolio positioning

Despite the outperformance of growth (relative to value) over the last decade, the DNR Capital Australian Equity Income Strategy has achieved its objectives and exceeded its benchmark and the broader market.

We are a quality investment manager with a neutral investment style (neither growth nor value), albeit with a robust valuation discipline.

We continue to position the portfolio in high-quality businesses that offer a combination of growing dollar income, franking benefits and attractive valuations.

Given the uncertainty, we are maintaining a balanced portfolio across three broad thematics.

Quality defensives: Industry leading stocks that should be able to win market share regardless of the economic cycle and pass inflation onto customers (e.g. IPH, TLS).

COVID-19 recovery plays: Quality stocks that have been oversold following the negative impact of lockdowns and are early in the recovery phase (e.g. CSL, SCG).

Inflation beneficiaries: Stocks that should benefit from higher inflation and higher interest rates and where valuations are attractive (e.g. SUN, WDS).

Portfolio characteristics

We continue to position the portfolio in high-quality businesses that offer a combination of attractive dividend yields, growth, franking benefits and importantly, valuation support.

Our portfolio of quality names with attractive risk-return characteristics should deliver a growing dollar income outcome through the cycle.

The Income Portfolio is expected to generate a gross yield of 5.8% (including franking) for the calendar year 2022, very attractive relative to alternatives.

- The quality characteristics of the Portfolio are attractive relative to the Fund's benchmark:
 - 2-year forward return on equity is above the market at 11.5% compared to 11% for the benchmark.
 - 2-year forward dividend yield is 4.5% compared to the benchmark at 4.0%.
 - 2-year forward earnings growth and dividend growth expectations are in line with market growth rates at ~8% and ~7% respectively
- Despite having stronger growth and quality characteristics relative to the market, the valuation is more attractive:
 - 2-year forward PE is at 14.9x compared to 16.9x for the benchmark.
- In addition, despite the superior growth outlook, the defensive attributes of the Portfolio have been maintained:
 - 2-year forward free cash flow yield is 6.1% compared to the benchmark at 4.6%.

Portfolio categories

At DNR Capital, we categorise income-generating companies as:

Growers – High-conviction stocks that may be paying a below-market dividend yield, however, we see a clear path towards delivering a sustainable and growing income profile in the medium term (ALX).

Compounders – Quality stocks operating within a robust industry structure that have a strong competitive position, underpinning attractive and sustainable income growth (MQG).

Cows – Stocks with a solid balance sheet and capital management potential that are being undervalued on traditional earnings-based metrics (WES).

Yielders – Quality companies at attractive valuations that are delivering sustainable and cash-backed dividends, but with little growth (BHP).

Key risks

Key risks to the Portfolio include:

- **Political environment.** The crisis in Ukraine and sanctions against Russia are severely impacting commodities markets, with the potential to destabilise the region and cause global inflationary shocks. Regional tensions with China also continue to pose risks to trade.
- **COVID-19 disruption.** The development of vaccine-resistant COVID-19 variants or sustained supply chain impacts still poses risks, especially with government support mostly withdrawn.
- **Interest rates.** Low interest rates have been a primary driver of markets over the past few years. With markets now pricing monetary tightening, changes to this trajectory or further inflationary shocks would have a significant impact on valuations.
- **Global growth.** Sanctions against Russia are driving up energy prices and creating global energy security concerns. Historically, sustained price shocks in oil have impacted global growth and catalysed recessions.

Stock moves

Sale of Coles Group (COL)

We have exited our position in COL. Supermarkets are lapping tailwinds from COVID-19, with normalising consumer behaviour leading to increased mobility and eating out. Whilst working from home trends are likely to linger, a return to the office in coming quarters will further ease benefits realised from home meals. Labour shortages and supply chain disruptions are expected to negatively impact food retail in the near term. We also see execution risk on ambitious e-commerce infrastructure/supply chain projects, with key initiatives already delayed and at risk of cost blowouts. Despite food inflation benefits being realised, increased online penetration and competition is likely to further offset some margin benefits in the medium term. Whilst valuation is fair, we see better risk/return opportunities elsewhere.

Investment strategy

The Australian Equities Income Portfolio has an investment style best described as 'style neutral' with above-average income and associated franking credits. The security selection process has a strong bottom-up discipline and focuses on buying quality businesses at reasonable prices.

The Australian Equities Income Portfolio also has a preference for securities that have high and sustainable dividend capability, strong profit-to-cash conversion, and relatively assured earnings growth. Securities that generate franking credits predominate.

We define quality businesses as being those with the following six attributes:

- earnings strength (particularly improving return)
- superior industry position
- a sound balance sheet
- strong management
- low environmental, social and governance (ESG) risk
- Income sustainability / growth

The focus of the Portfolio is on yield. We are focused on a growing, sustainable dividend yield above the market.

Where we are satisfied that a security possesses quality characteristics then it is eligible for inclusion in the Portfolio. However, it must also represent value and sit comfortably within our Portfolio construction requirements.

A range of valuation methodologies are used depending on the nature of the business being assessed to identify mispriced opportunities.

The Portfolio construction process is influenced by a top-down economic appraisal and also considers the risk characteristics of the Portfolio, such as security and sector correlations.

Investment philosophy

DNR Capital believes a focus on quality businesses will enhance returns when it is combined with a thorough valuation overlay. We seek to identify quality businesses that are mispriced by overlaying a quality filter, referred to as the 'quality web', with a strong valuation discipline. The Portfolio is high conviction and invests for the medium term.

Platform access

- AMP My North
- BT Panorama (Direct, Compact and Full)
- Colonial First State FirstWrap
- Federation Alliance
- HUB24
- Macquarie Wrap
- Mason Stevens
- Netwealth
- OneVue
- Powerwrap
- Praemium
- Wealthtrac

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