

DNR Capital Australian Equities Income Portfolio

Performance Report September 2022

Performance

The DNR Capital Australian Equities Income Portfolio outperformed the S&P/ASX 200 Industrials Accumulation Index by 1.40% in September. The Portfolio's dividend yield expectation for 2022 is currently 4.40% (5.68% grossed up for franking credits).

Gross active return as at 30 September 2022

	1mth %	3mth %	1yr %	3yr p.a. %	5yr p.a. %	7yr p.a. %	10yr p.a. %	Incep.* p.a. %
Income Portfolio	-6.19	-1.14	-3.05	6.04	8.59	9.23	11.77	7.72
S&P/ASX 200 Industrials Accumulation Index	-7.59	-0.47	-13.48	0.71	4.99	6.34	8.76	4.96
Excess return	1.40	-0.67	10.43	5.33	3.60	2.89	3.01	2.76
Income Portfolio dividend yield incl. franking credits¹	0.92	2.11	6.15	5.70	6.82	7.33	9.32	7.17
Franking %	87.3	83.7	77.5	75.4	75.4	74.0	72.1	71.5

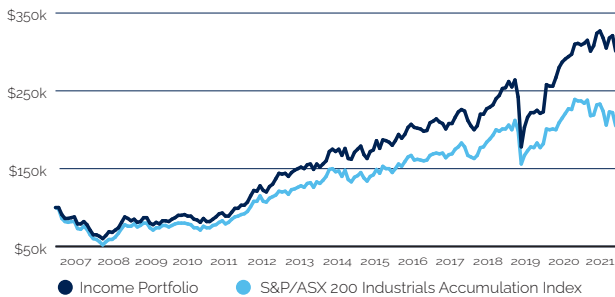
*Inception date—December 2007.

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).

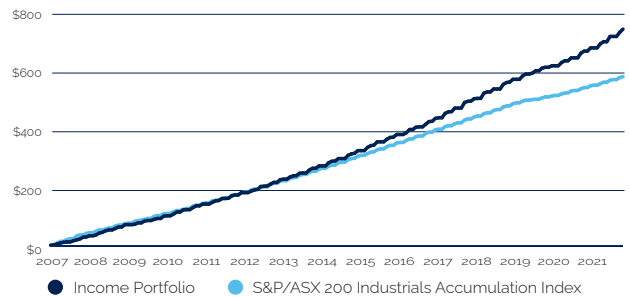
Performance data relates to the DNR Capital model Portfolio. Performance of an investment in this model portfolio through a Portfolio Service may have different performance to the performance in this monthly update as a result of different policies and procedures at different Portfolio Service operators.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



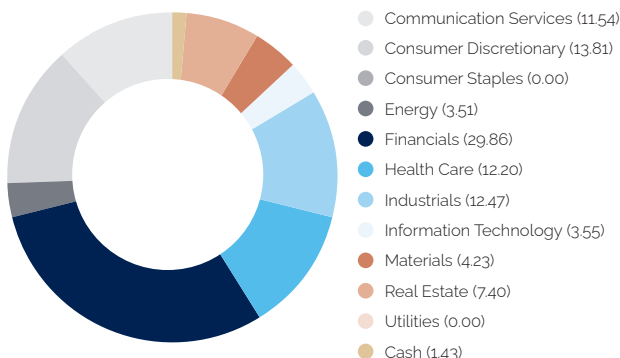
Source: DNR Capital

Accumulated income from \$1,000 since inception



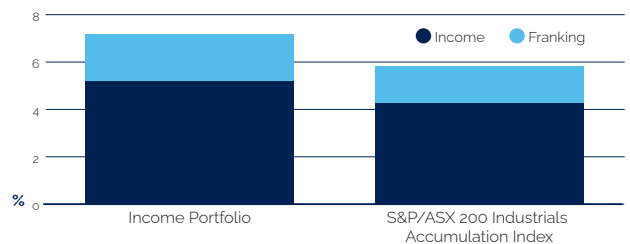
Source: DNR Capital

Sector weightings %



Source: DNR Capital

Income yield incl. franking credits since inception



Source: DNR Capital

Experienced portfolio managers



Top 5 active holdings

Security details

The Lottery Corporation (TLC)

QBE Insurance Group (QBE)

Woodside Energy Group (WDS)

Suncorp Group (SUN)

Scentre (SCG)

Monthly top contributors and detractors

Top 3 contributors

		Alpha*
Goodman	No Holding	0.27%
IPH	Overweight	0.20%
Computershare	Overweight	0.20%

Top 3 detractors

Domino's Pizza Enterprises	Overweight	-0.24%
Scentre	Overweight	-0.22%
ANZ Banking Group	Underweight	-0.18%

* 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

- **Goodman (GMG, no holding):** underperformed during the period, following a sell-off in the bond market. GMG remains one of the most sensitive companies in the Australian market to the movement in bond rates, given its asset base and earnings streams. As a fund manager, developer and owner of commercial property, its earnings, margins and balance sheet remain closely tied to the valuations of those property assets.
- **IPH (IPH):** outperformed during the period, benefitting from favourable currency moves. IPH generates revenue largely in USD, which has seen strong gains against the local AUD. This, along with its defensive characteristics in a potentially recessionary environment has seen it re-rate higher.
- **Computershare (CPU):** expectations regarding inflation and interest rates saw interest re-emerge.

Detractors

- **Domino's Pizza Enterprises (DMP):** underperformed as concerns over its European earnings grow as inflation and the general economic conditions deteriorate in key markets. We view the group as well positioned to navigate inflation, but DMP remains exposed to energy costs, labour availability and adverse currency movements. Current valuation is compelling despite these challenges, and we remain attracted to the long-term store rollout opportunity.

- **Scentre (SCG):** underperformed during the period, following a sell-off in the bond market. REITs are sensitive to bond yields due to their inherent relationship with capitalisation rates, which are used to value a REITs rental stream.
- **ANZ Banking Group (ANZ):** higher interest rates are driving expectations of margins into the FY22 result.

Portfolio and market review

The S&P/ASX 200 Industrials Accumulation Index was down 7.59% during the period. Healthcare (-5.1%) was the best performing sector, with the defensive nature of key companies such as CSL (CSL -2.9%) attracting investors in the face of recession fears. Consumer staples (-5.8%) also outperformed, similarly benefitting from its relatively defensive earnings characteristics, with grocers Woolworths Group (WOW -5.9%) and Coles Group (COL -6.4%) the largest constituents. Utilities (-14.9%) was the worst performing sector, as bond rates moved higher and Origin Energy (ORG -18.1%) announced the early closure of the Eraring power plant. REITs (-13.8%) also underperformed, similarly impacted by surging bond rates which are direct comparators to REIT cap rates.

Global equities fell (MSCI World Index -9.30%) in September as global recession fears intensified with the Federal Reserve (Fed) maintaining its aggressive attitude towards fighting inflation. Large currency and bond market moves created further uncertainty for markets. Bond markets now reflect a hawkish outlook, with the Australian 10-year yield increasing to 3.89% and US yields increasing to 3.80%. Higher yields act as a headwind for valuations, which have had a disproportionate negative impact on industrial stocks relative to resource stocks. The S&P/ASX 200 Industrials Accumulation Index (the strategy's benchmark) outperformed global markets but still fell (-7.29%) during September.

Recession scenario not in earnings forecasts... yet

All major super sectors have seen meaningful de-ratings throughout 2022. The Industrials ex-Financials sector has de-rated from above ~30x to ~22x. Resources have nearly halved to ~7x, whilst the Financials sector has chipped away towards ~13x.

Exhibit 1: Market Valuations Continued to Drift Lower Over September



Source: Factset, IBES, Morgan Stanley Research. Data as at September 30, 2022

The ASX200 Industrials Index (strategy benchmark) is now trading broadly in-line with the historical average of ~16x 12-month forward PE. However, this only represents fair value if earnings forecasts are correct.

Exhibit 73: ASX 200 Industrials 12mf Price-to-Earnings (Latest = 16.5x)



Source: RMES, IBES, Morgan Stanley Research. Data as at September 30, 2022

Sentiment has turned bearish and investors are looking for reasons to be bullish, arguing that equity markets are down enough to account for the widely predicted forthcoming recession. However, the equity market sell-off largely reflects a valuation de-rating which has been driven by rising real yields, not EPS downgrades. The 12-month forward consensus EPS forecasts have been minor to date, whilst historically, downgrades >10% are typical in a recession scenario.

Exhibit 6: Double-digit downgrades typical in recession

Revisions to forecast global EPS & global PMI



Source: JP Morgan/S&P Global, IBES/DataStream, NBER; Minack Advisors

Albanese, Labor and franking

Despite a pledge not to change franking credits prior to the election, the Albanese government has recently proposed to retrospectively stop companies paying fully franked dividends to shareholders that are funded by capital raisings. If formalised, it is expected the policy will date back to 2016. In broad terms, a company will be considered to be funding dividends from a capital raising if it is not consistent with established practice (i.e. making such payouts on a regular basis).

As it stands, this would have an immediate impact on investors in companies that raised capital during the COVID-19 pandemic, only to return it to shareholders once the impact of the pandemic was weathered. For example, Westpac Banking Corporation (WBC) and Harvey Norman Holdings (HVN). Going forward it will also have an impact on future potential capital management initiatives. As most companies don't pay out all their profits to shareholders, they build up franking credits over time. Historically, special dividends and off-market buybacks have been used to return franking credits to investors. Special dividends can still be paid, albeit without franking attached, reducing its appeal. Off-market share buybacks will also be affected, the extent to which will depend on the "capital component" and "dividend component" (franking credits are usually attached to the dividend component).

We note it is still early days and the policy has been put out for consultation (submissions due 5 October 2022). We will continue to monitor and update.

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.

Disclaimer

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