

Australian Equities Income Portfolio

Performance Report – May 2022

Market overview and portfolio performance



Scott Kelly
Portfolio Manager



Jamie Nicol
Chief Investment Officer

The S&P/ASX 200 Industrials Accumulation Index was down 3.74% during the period.

Utilities (-0.2%) was the best performing sector, with AGL (AGL +0.9%) bowing to activist shareholder pressure to ditch its demerger plans. Industrials (-0.5%) also outperformed, with defensive infrastructure names such as Transurban (TCL +0.2%), Brambles (BXB +3.1%) and Atlas Arteria (ALX +3.3%) supporting the sector. REITs (-8.7%) was the worst performing sector, with increasing bond yields putting pressure on valuations, given the direct comparison to property cap rates. Information Technology (-8.7%) also underperformed, with their sensitivity to higher bond rates and lower growth evident again.

The DNR Capital Australian Equities Income Portfolio outperformed the Index for the month. Key stock contributors were BHP Group (BHP), IPH (IPH) and Goodman (GMG, No Holding). Key stock detractors were Commonwealth Bank of Australia (CBA, No Holding), Lendlease (LLC) and Westpac Banking Corporation (WBC, Underweight).

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

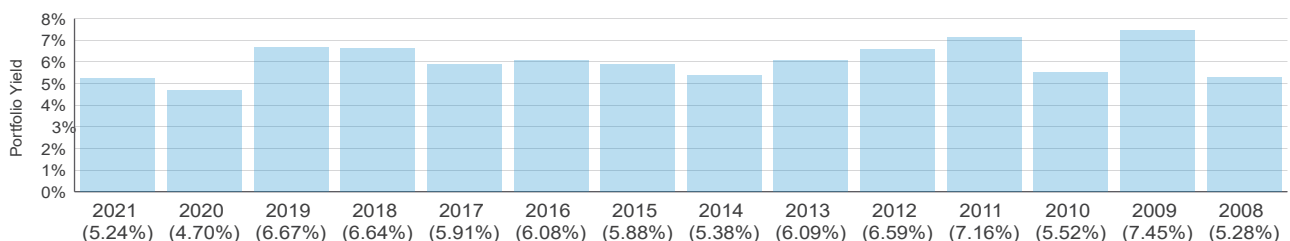
The Portfolio's dividend yield expectation for 2022 is currently 4.3% (5.8% grossed up for franking credits).

Gross active return

	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Income Portfolio	-2.79	3.31	2.35	9.13	11.50	9.40	8.87	13.62	8.30
S&P/ASX 200 Industrials Accumulation Index	-3.74	2.24	-4.14	1.48	6.12	6.80	6.24	11.03	5.72
Excess Return	0.95	1.07	6.49	7.65	5.38	2.60	2.63	2.59	2.58

* 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

Australian equities declined in May with the ASX 200 Industrials Index (the strategy's benchmark) down 3.7% as investors reacted to the RBA hiking the cash rate by 25bps to 0.35%. Elevated volatility was experienced during the month, defensives outperformed cyclicals and value outperformed growth. The DNR Capital Australian Equities Income strategy outperformed its benchmark.

RBA raising / Markets hawkish

At its May meeting, the RBA lifted the cash rate for the first time in more than 12 years. At time of writing, following its June meeting, the RBA announced a larger-than-expected increase in interest rates by 50bps to 0.85%. This is the highest one month lift in interest rates for 22 years.

Financial markets are now pricing an aggressive hiking path to ~3% by the end of 2022 and then to ~3.5% by mid-2023. Despite market expectations, significant uncertainty remains on the path ahead. Unemployment is at a 50-year low of 3.9% alongside record high labour participation, however wage growth remains well below prior cycles. And whilst debt servicing costs are low and savings rates are high, debt levels are substantially elevated relative to income.

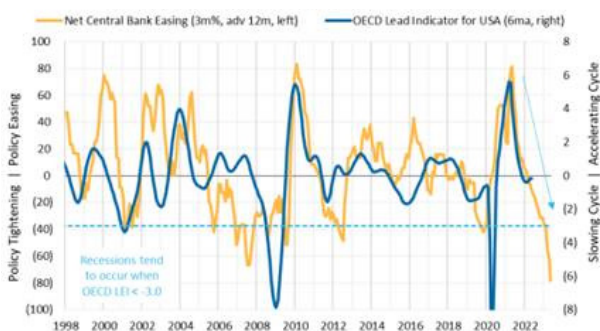
Nonetheless, further rate rises should be expected in the coming months, as *"The (RBA) board expects to take further steps in the process of normalising monetary conditions in Australia over the months ahead."* Energy and Materials sectors typically produce stronger returns during hiking cycles, whilst weaker returns are typically experienced by the Tech, Retail and REIT sectors.

Slowdown ahead?

We are now in a period of uncertainty with an uneasy mix of slower growth, higher inflation and faster policy normalisation. Risks are skewed to the downside, toward a more evident slowdown in 2023.

Stocks clearly benefited from unprecedented stimulus during the pandemic, but global central banks are now tightening at the fastest pace in decades. This tightening is a good leading indicator of the growth cycle and hikes signal continuing headwinds for equities.

Global monetary policy cycle leads US growth cycle



Source: FactSet, Macquarie Research, May 2022

Global monetary policy cycle leads US manufacturing cycle

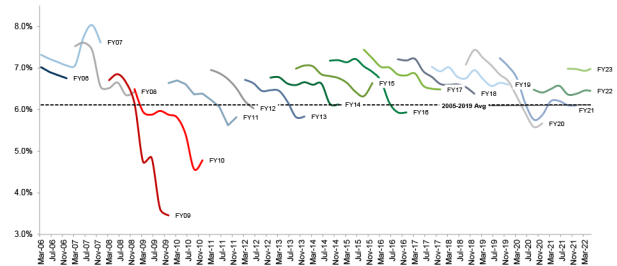


Source: FactSet, Macquarie Research, May 2022

Corporate profit margin risk

Despite very high levels of cost inflation, a combination of both strong demand and short supply has allowed some corporates to expand margins. Consensus forecasts for the ASX 200 Industrials Index expect profit margins to be ~7%, the highest level since prior to the Financial Crisis. Consensus downgrades are likely.

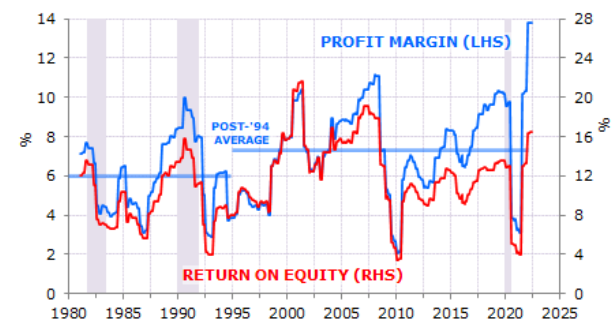
Consensus forecasts imply that FY23 NPAT margins will be 90bps above the pre-Covid average. Revision to pre-covid margins implies a c.13% cut to NPAT forecasts



Source: FactSet, Goldman Sachs Global Investment Research

Profit margins are likely to suffer as softening demand meets higher costs. The chart below highlights the large expansion in profit margins post the fiscal stimulus that accompanied COVID-19. Profit margins are typically mean reverting, meaning they revert to an average as competition competes away excess returns.

Market excluding resources and financials



Source: Minack Advisors

Market valuations remains elevated, albeit dispersed

The ASX 200 Industrials Index 12-month forward PE sits at ~18.5x, still elevated relative to history.

ASX industrials forward PER (x) vs recessions



Source: FactSet, Macquarie Research, May 2022

We also note that the headline PE masks dispersion within markets.

High PE firms trade at a 80% premium to the market, which is 39% above the 20-yr average



Source: Goldman Sachs Global Investment Research

Low PE firms trade at a 57% discount to the market, which is 11% below the 20-yr average



Source: Goldman Sachs Global Investment Research

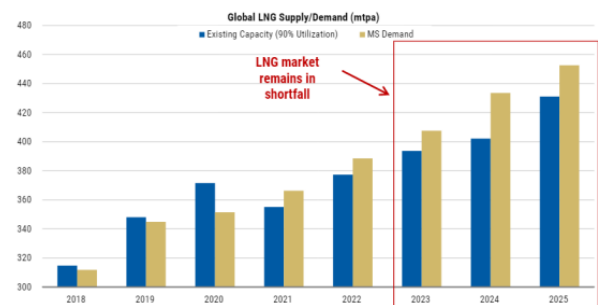
Energy a key exposure

Resources and energy stocks continue to trade at low multiples, especially in context of spot commodity prices. Growth stocks have de-rated but remain well above ten year averages, and arguably have further to fall.

Woodside Energy (WDS) is a key portfolio holding. The BHP Petroleum merger has transformed the business. Its balance sheet is reset, providing significant flexibility for the company to fund growth, distribute excess capital and prepare for the energy transition.

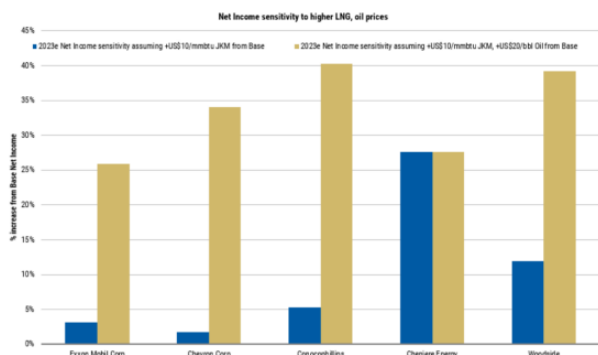
The Russia/Ukraine situation has highlighted how difficult it is to deliver new LNG supply quickly into regions that need them. With Europe's search for more gas underway, prices have surged and it may take a number of years to return to some level of normality. WDS is more leveraged to the LNG thematic than the large multinational energy companies which dominate the industry.

The global LNG market looks set to remain in a shortfall through the mid-2020s, requiring higher prices to constrain demands



Source: WoodMackenzie, Morgan Stanlet Research estimates

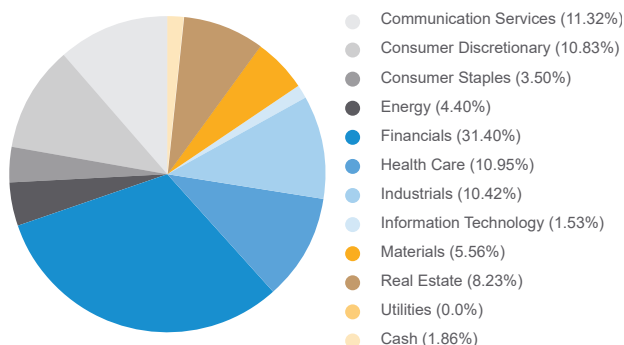
Woodside's leverage to rising LNG prices



Source: Morgan Stanlet Research estimates

Portfolio attribution

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors		Alpha*
BHP Group	Overweight	0.32%
IPH	Overweight	0.29%
Goodman	No Holding	0.26%
Top 3 detractors		
Commonwealth Bank of Australia	No Holding	-0.47%
Lendlease	Overweight	-0.38%
Westpac Banking Corporation	Underweight	-0.34%

12 month - top contributors and detractors

Top 3 contributors		Alpha*
Woodside Energy Group	Overweight	1.67%
Macquarie Group	Overweight	0.74%
National Australia Bank	Overweight	0.73%
Top 3 detractors		
SKYCITY Entertainment Group	Overweight	-1.20%
Commonwealth Bank of Australia	No Holding	-0.86%
Super Retail Group Limited	Overweight	-0.50%

* 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.

Attribution

The top stock contributors for the month were:

- BHP Group (BHP):** outperformed over the month as China's COVID-19 lockdowns eased helping sentiment towards iron ore producers. 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.
- IPH (IPH):** outperformed during the month as the market favoured defensive exposures and a stronger US\$ also assisted share price performance.
- Goodman (GMG, No Holding):** underperformed during the period, as higher bond rates begin to put pressure on industrial property valuations, which are sitting near all-time highs. The GMG business model can be impacted in multiple ways by higher rates, including through lower direct ownership valuations, management fees and development margins.

The top stock detractors for the month were:

- Commonwealth Bank of Australia (CBA, No Holding):** banks enjoyed a rally on expectations higher rates will assist margins. Note we remain cautious on the potential impact on the housing market.
- Lendlease (LLC):** underperformed during the month as the outlook for higher rates weighed on the property sector generally. Management continues to make incremental progress towards their stated 2024 target return targets with a sharpened focus on executing the exiting development backlog of over \$100bn.
- Westpac Banking Corporation (WBC, Underweight):** banks enjoyed a rally on expectations higher rates will assist margins. Note we remain cautious on the potential impact on the housing market.

Portfolio positioning

Despite the outperformance of growth (relative to value) over the last decade, the DNR 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.

This focus on valuation has resulted in the Strategy's current value tilt.

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

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

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 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 11.0% compared to 10.5% for the benchmark.
 - 2-year forward dividend yield is 4.6% 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 ~9% respectively
- Despite having stronger growth and quality characteristics relative to the market, the valuation is more attractive:
 - 2-year forward PE is at 14.7x compared to 17.0x 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 5.9% compared to the benchmark at 4.4%.

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, however 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.

Portfolio moves

No stock moves to report for May.

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

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Office address
Level 23
307 Queen Street
Brisbane QLD 4000

Postal address
GPO Box 3263
Brisbane QLD 4001

Telephone
07 3229 5531

Email
info@dnrcapital.com.au

Website
www.dnrcapital.com.au