DNR Capital

Australian Equities Income Portfolio

Performance Report – March 2022

Market overview and portfolio performance

Scott Kelly
Portfolio Manager

Jamie Nicol
Chief Investment Officer

The S&P/ASX 200 Industrials Accumulation Index was up 5.82% during the period.

Information Technology (+13.2%) was the best performing sector, with key constituents Wisetech (WTC +17.2%), Computershare (CPU +14.0%) and Xero (XRO +9.6%) all stronger. Financials (+8.3%) also outperformed with the banks benefitting from a higher rates outlook and stubbornly low bad debts. A-REITs (+1.2%) were the worst performing sector, as bonds sold off sharply during the month, increasing funding costs and discount rates. Health Care (+1.9%) also underperformed, with COVID-19 beneficiaries Fisher & Paykel Healthcare (FPH -12.5%) and Resmed (RMD -2.9%) pulling the sector down.

The DNR Capital Australian Equities Income Portfolio underperformed the Index for the month. Key stock contributors were Woodside Petroleum (WPL), National Australia Bank (NAB) and James Hardie Industries (JHX, No Holding). Key stock detractors were Commonwealth Bank of Australia (CBA, No Holding), IPH (IPH) and SKYCITY Entertainment Group (SKC).

The Fund's dividend yield expectation for 2022 is currently 3.7% (5.0% grossed up for franking credits).

Portfolio overview

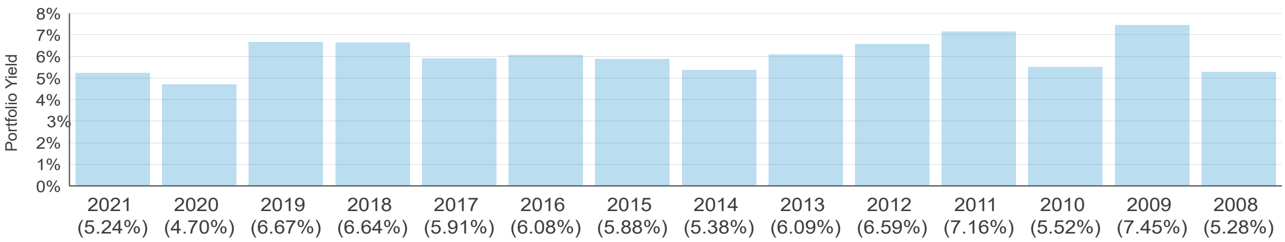
Investment bias	Style neutral
Designed for	Investors who seek a greater level of income and who can make use of franking credits
Benchmark	S&P/ASX 200 Industrials Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Industrials Accumulation Index and deliver higher levels of income (before 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

Gross active return

	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Income Portfolio	5.20	2.61	4.18	15.55	13.80	9.74	9.16	13.43	8.54
S&P/ASX 200 Industrials Accumulation Index	5.82	-2.58	-2.14	11.01	9.29	7.10	6.39	11.09	6.05
Excess Return	**-0.62**	**5.19**	**6.32**	**4.54**	**4.51**	**2.64**	**2.77**	**2.34**	**2.49**

** 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

Market update

March was a strong month for Australian equities. The ASX 200 Industrials Index (the strategy's benchmark) rose +5.8%. Australian equities outperformed global markets again, driven by strong commodity prices, banks and a rebound in technology stocks.

The outlook for equities is more challenging than it has been for some time. The end of quantitative easing, higher interest rates and rising inflation increases the risks for investors.

Australia, however, looks relatively well placed given our ability to supply the commodities (LNG, coal, wheat etc) from a politically secure environment, which should support our terms of trade (TOT).

Rising TOT enables Australia to purchase more imports for a given quantity of exports, thereby increasing domestic real income. This supports employment, government revenues and increased shareholder profits.

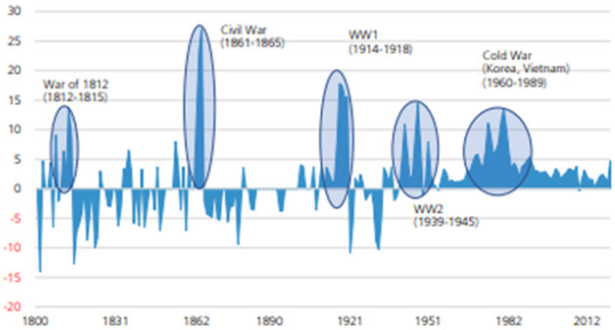
Australia is well positioned relative to other developed world economies given the demand for resources benefits Australia through the TOT.

Persistent inflation

We are being met by the reality of more persistent inflationary signals and clear central bank intent to normalize monetary policy settings.

Russia's invasion of Ukraine has added to supply risks for commodities. War is historically inflationary as capacity is taken out of the global economy. Europe needs to replace Russian supply of many commodities but especially gas, pushing prices higher.

US CPI annual percentage change (rate of inflation)



Source: UBS, www.minneapolisfed.org

There are also other big shifts occurring in market forces that could result in higher commodity prices, sustained inflation and unwind decades of globalisation efficiencies. These include:

- The renewable transition driving demand for commodities and resulting in higher prices.
- Company's building resiliency in production and sourcing and protecting supply chains, following years of disruption from COVID-19 lockdowns.
- Rearmament and increased defence spending.
- Chinese economy has remained subdued, impacted by the harsher lockdowns during COVID-19 and by Government actions to subdue the property market. Recent activity suggests they are seeking to provide greater stimulus to support the economy.
- Supply remains constrained with a number of drivers influencing this including a decade of under-investment and ESG / regulation pressures constraining the emergence of new supply.

These are all additional and significant inflationary pressures, which could easily take investors back to a future heavily influenced by rising yields and rising rates. Many investors have never seen this.

Is volatility a bad thing?

Geopolitics and increasingly hawkish central banks are pushing market volatility, evidenced by large wild intraday moves.

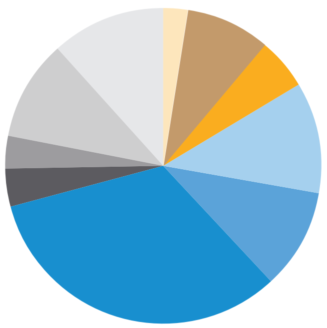
As active portfolio managers, we regard volatility as a good thing. Volatility provides opportunities and we have been selectively increasing exposure to our high conviction positions.

We have reduced the number of stocks held in the portfolio to 21 (from 25) and increased our portfolio active weight from ~60% to over ~65%.

This primarily represents increased confidence around high conviction ideas with attractive risk-return metrics, whilst maintaining a balanced and diversified portfolio.

Portfolio attribution

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors		**Alpha***
Woodside Petroleum	Overweight	0.31%
National Australia Bank	Overweight	0.23%
James Hardie Industries	No Holding	0.19%
Top 3 detractors		
Commonwealth Bank of Australia	No Holding	-0.77%
IPH	Overweight	-0.40%
SKYCITY Entertainment Group	Overweight	-0.30%

12 month - top contributors and detractors

Top 3 contributors		**Alpha***
Woodside Petroleum	Overweight	1.60%
Macquarie Group	Overweight	0.78%
Afterpay	No Holding	0.77%
Top 3 detractors		
Commonwealth Bank of Australia	No Holding	-1.70%
SKYCITY Entertainment Group	Overweight	-1.05%
Lendlease	Overweight	-0.93%

** 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:

- **Woodside Petroleum (WPL):** outperformed during the period on the back of higher oil and gas prices. An emerging global energy shortage has been exacerbated by the invasion of Ukraine, with implicit and explicit sanctions on Russia restricting supply into an already tight market. Many LNG shipments previously destined for Asia are being re-routed towards Europe at higher prices to plug the Russian gap.
- **National Australia Bank (NAB):** bounced with expectations that the yield curve is helpful for earnings. NAB continues to win share versus other majors.
- **James Hardie Industries (JHX, No Holding):** Sold off on concerns higher interest rates will impact earnings and the housing market.

The top stock detractors for the month were:

- **Commonwealth Bank of Australia (CBA, No Holding):** bounced with expectations that the yield curve is helpful for earnings. We also saw foreign investors deploying into Australia with CBA likely being a beneficiary of this flow of money.
- **IPH (IPH):** underperformed in March on limited news flow. The company exhibits defensive characteristics which can lead to some correlation with bonds which were sold down sharply in the period. The company also has significant exposure to USD earnings which have been negatively impacted by a strengthening Australian Dollar.
- **SKYCITY Entertainment Group (SKC):** was weaker over the month. While there was no material news flow for SKC, the broader casino industry continues to face increasing scrutiny following the review into Crown Resorts (CWN) and The Star Entertainment Group (SGR).

Portfolio positioning

Despite the outperformance of growth (relative to value) over the last decade, the DNR Capital Australian Equities 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 Portfolio's current value tilt.

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

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

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

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

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 5.0% (including franking) for calendar year 2022, very attractive relative to alternatives.

- The quality characteristics of the Portfolio are attractive relative to the Portfolio's benchmark:
  - 2-year forward return on equity is above the market at 10.5% compared to 10% for the benchmark.
  - 2-year forward dividend yield is 4.2% compared to the benchmark at 3.7%.
  - 2-year forward earnings growth and dividend growth expectations are in line with market growth rates at ~10% and ~8% respectively
- Despite having stronger growth and quality characteristics relative to the market, the valuation is more attractive:
  - 2-year forward PE is at 16.2x compared to 18.2 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 5.1% compared to the benchmark at 4.3%.

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

Sale of Virgin Money UK (VUK)

We have exited our position in VUK due to the increased risk of a recession in Europe resulting from the impact of the Russia invasion of Ukraine and specifically higher energy prices. The UK economy is likely to be negatively impacted by a slowdown in Europe resulting in higher bad debts. We have deployed the proceeds across other existing positions in the portfolio that have better resiliency characteristics and where risk / return metrics are more favourable.

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)
- Coloinal First State FirstWrap
- Federation Alliance
- HUB24
- Linear
- Macquarie Wrap
- Mason Stevens
- Netwealth
- OneVue
- Powerwrap
- Praemium
- Wealthtrac

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

DNRINCR.4.15.2203