

DNR Capital Australian Equities Income Portfolio

Performance Report October 2022

Performance

The DNR Capital Australian Equities Income Portfolio underperformed the S&P/ASX 200 Industrials Accumulation Index by -0.91% in October. The Portfolio's dividend yield expectation for 2022 is currently 5.25% (6.01% grossed up for franking credits).

Gross active return as at 31 October 2022

	1mth %	3mth %	1yr %	3yr p.a. %	5yr p.a. %	7yr p.a. %	10yr p.a. %	Incep.* p.a. %
Income Portfolio	6.85	1.05	4.03	8.22	8.99	9.48	12.05	8.15
S&P/ASX 200 Industrials Accumulation Index	7.76	-0.83	-6.89	3.27	5.76	6.86	9.23	5.46
Excess return	-0.91	1.88	10.92	4.95	3.23	2.62	2.82	2.69
Income Portfolio dividend yield incl. franking credits¹	0.00	2.02	6.18	5.64	-6.52	6.99	9.01	7.12
Franking %	0.0	78.1	77.5	76.0	75.5	73.9	72.2	71.5

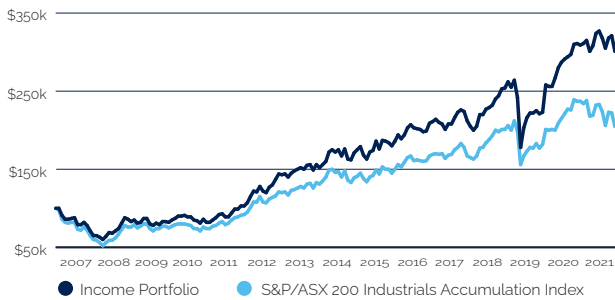
*Inception date—December 2007.

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).

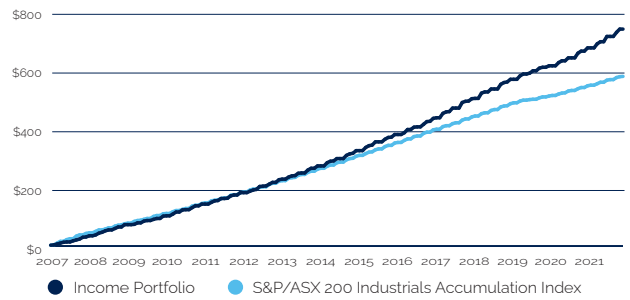
Performance data relates to the DNR Capital model Portfolio. Performance of an investment in this model portfolio through a Portfolio Service may have different performance to the performance in this monthly update as a result of different policies and procedures at different Portfolio Service operators.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



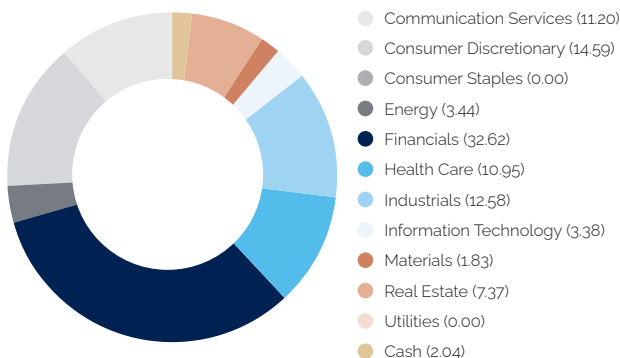
Source: DNR Capital

Accumulated income from \$1,000 since inception



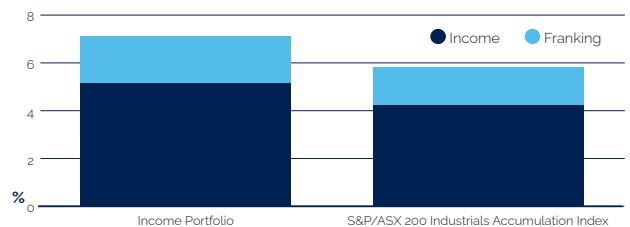
Source: DNR Capital

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 (QBE)

Woodside Energy (WDS)

Scentre (SCG)

Suncorp Group (SUN)

Monthly top contributors and detractors

Top 3 contributors

		Alpha*
Domino's Pizza Enterprises	Overweight	0.39%
Woolworths Group	No Holding	0.31%
Scentre	Overweight	0.21%

Top 3 detractors

Commonwealth Bank of Australia	No Holding	-0.84%
Lendlease	Overweight	-0.29%
Rio Tinto	Overweight	-0.23%

* 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

- Domino's Pizza Enterprises (DMP):** outperformed during the month, bouncing off its previous month lows on no stock specific news. Subsequent AGM trading updates highlighted ongoing pressures in Europe which the group continues to manage in the face of steep inflation.
- Woolworths Group (WOW, no holding):** underperformed following a weaker than expected quarterly sales update. Whilst food prices grew strongly, volumes fell as consumers returned to dining out as well as market shares normalising following COVID-19 restrictions. WOW's New Zealand business also deteriorated markedly, with earnings expectations downgraded. The group remains well positioned in the supermarkets industry but remains expensive versus peers and its historic multiples.
- Scentre (SCG):** outperformed during the month, rallying with duration equities. The step-down of rate increase sizing from 0.50% to 0.25% by the RBA, along with the accompanying incrementally dovish commentary, was enough to cause a rally in REITs and other bond-proxies. SCG continues its recovery from lockdown periods, with physical retail sales supporting strong tenant demand for space.

Detractors

- Commonwealth Bank of Australia (CBA, no holding):** banks bounced due to higher interest rates feeding through to better margins in the short term. In the longer term we remain concerned regarding the impact of higher rates on bad debts, higher costs and competition eating away improved margins
- Lendlease (LLC):** underperformed during the month as the outlook for higher rates weighed on the

property sector generally. High interest rate volatility and general economic uncertainty is slowing development activity and delaying the progress towards the 2024 targets.

- Rio Tinto (RIO):** the benefit of stabilising iron ore prices was offset by weakness in the aluminium markets with several competitors reporting soft results. Whilst RIO's aluminium businesses will be impacted, the business is well diversified and positioned at the low end of the cost curve.

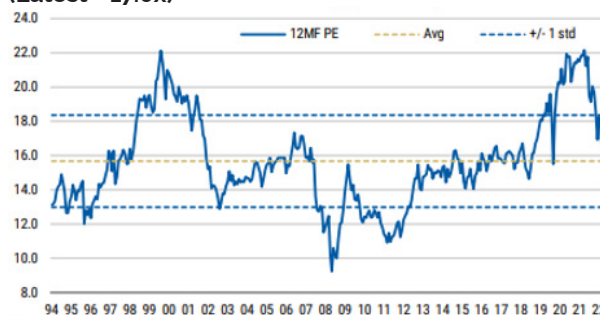
Portfolio and market review

The S&P/ASX 200 Industrials Accumulation Index was up 7.76% during the period. Financials (+12.2%) was the best performing sector, with the big banks benefitting from increasing net interest margins while maintaining record low bad debts. A-REITs (+9.9%) also outperformed, with bond rates retreating from their highs, feeding directly into lower expectations for property capitalisation rates. Consumer Staples (-0.2%) was the worst performing sector, with a poor quarterly report from Coles Group (COL -0.6%) highlighting a moderation of operating conditions from COVID-19 highs. Health Care also underperformed; with sector heavyweight CSL (CSL -1.6%) giving back some recent outperformance.

Equities had a strong month in October, mostly reversing September's drawdown. Speculation that central banks are nearing the peak of policy tightening broadly lifted sentiment. Investors responded to a more dovish than expected RBA 25bps hike to 2.60% which was reflected in Australian bond markets, as the Australian 10-year yield moved down by 13bps to 3.76%. Meanwhile US yields continued their upward trend, rising 28bps to 4.07%, however the potential for a pivot in the Fed's policy path supported risk sentiment.

The S&P/ASX 200 Industrials Index 12-month forward PE remains slightly above the long-term average at ~17x, albeit the risk of EPS downgrades remains.

Exhibit 74: ASX 200 Industrials 12mf Price-to-Earnings (Latest = 17.0x)



Banks tailwinds to become headwinds

Bank earnings lifted in the month (upgraded +5% across FY23- FY25) as near-term margin tailwinds and lucrative deposit pricing were incorporated into forecasts. There remains upside risk to 1H23 margins driven by rising cash rates and profitable retail term deposit spreads. However, these benefits are relatively well understood and are likely to be partly offset by increasing expenses,

slowing volume growth, increased completion and rising bad debts. Within the majors, we prefer National Australia Bank (NAB).

Australia banks and dividend yield



Source: Minack Advisers

Franking reform targets off-market buybacks

The government's 2022 budget included proposed changes to off-market buybacks, aligning the tax treatment with on-market share buybacks. Importantly it will not be applied retrospectively. Historically, off-market buybacks have been used by Australian companies to distribute franking credits to low-tax rate shareholders. The Commonwealth Bank of Australia (CBA) first used this scheme in 1997 and since then ~\$50bn of cash and ~\$17bn of imputation tax credits have been distributed to shareholders. The government estimates that the change will increase receipts by \$550m over the four years from 2022-23. Under the new scheme, there is the increased risk that franking credits will become permanently trapped within companies, albeit we suspect companies will offset this risk by looking to increase dividend payout ratios and pay special distributions more regularly.

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 focused: 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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