

Australian Equities Income Portfolio

Performance Report – April 2022

Market overview and portfolio performance



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The S&P/ASX 200 Industrials Accumulation Index was up 0.37% during the period.

Utilities (+9.3%) was the best performing sector, with key constituents APA (APA +7.7%), Origin Energy (ORG +9.8%) and AGL (AGL +12.4%) all stronger on the back of stronger energy markets and ongoing private equity interest. Industrials (+3.4%) also outperformed with reopening plays such as Transurban (TCL +5.8%) and Qantas (QAN +7.5%) benefitting from increased normalisation of travel. Information Technology (-10.4%) was the worst performing sector, with increasing bond yields and inflation prompting a large sell off in expensive technology names in the US. Consumer Discretionary (-3.2%) also underperformed, with an emphasis of selling in higher growth companies and those who have benefitted throughout the COVID-19 period, where revenues may have been pulled forward.

The DNR Capital Australian Equities Income Portfolio outperformed the Index for the month. Key stock contributors were Lendlease (LLC), Block Inc (SQ2, No Holding) and Commonwealth Bank of Australia (CBA, No Holding). Key stock detractors were BHP Group (BHP), Qube Holdings (QUB) and IPH (IPH).

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 |

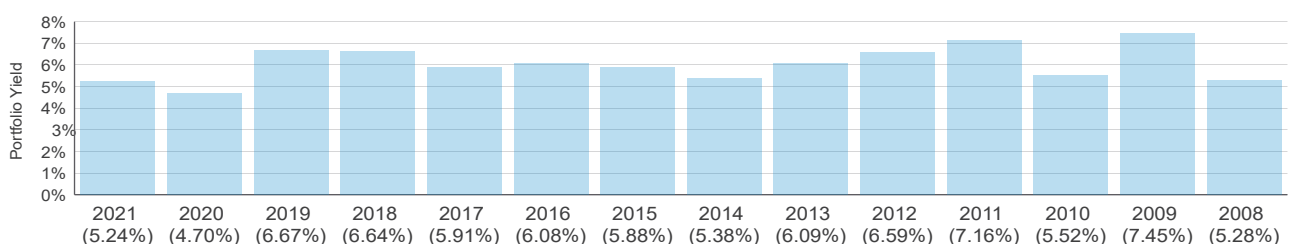
The Portfolio's dividend yield expectation for 2022 is currently 3.64% (4.84% grossed up for franking credits).

Gross active return

| | 1mth % | 3mth % | 6mth % | 1yr % | 3yr % | 5yr % | 7yr % | 10yr % | Incep.* % |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Income Portfolio | 1.02 | 8.69 | 5.69 | 13.89 | 13.00 | 9.55 | 9.59 | 13.38 | 8.56 |
| S&P/ASX 200 Industrials Accumulation Index | 0.37 | 6.97 | -1.92 | 8.19 | 8.12 | 6.85 | 6.88 | 10.91 | 6.04 |
| Excess Return | 0.65 | 1.72 | 7.61 | 5.70 | 4.88 | 2.70 | 2.71 | 2.47 | 2.52 |

* 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

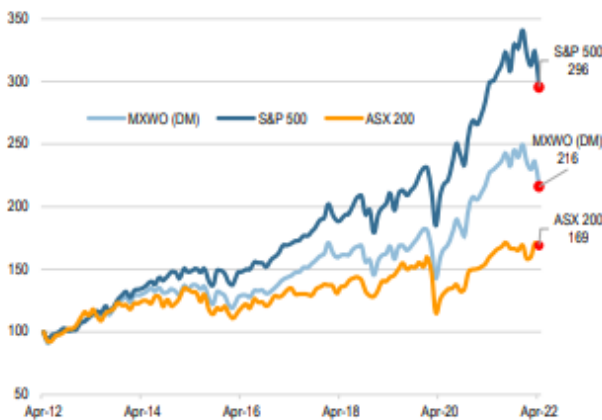
Performance data relates to the DNR Capital model portfolio. Performance of an investment in this model portfolio through a Portfolio Service may have different performance to the performance in this monthly update as a result of different policies and procedures at different Portfolio Service operators.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

Australian equities continue to fare well relative to global peers. April was a weak month for equities as rising inflation fears drove concerns of an economic slowdown. However, the ASX200 Industrials (strategy benchmark) was up 0.37% vs. -8.8% observed for the S&P 500. Utilities, Industrials and Consumer Staples were the best-performing sectors in April, whilst we observed a large drawdown within the Technology sector.

ASX underperforms global markets over last decade

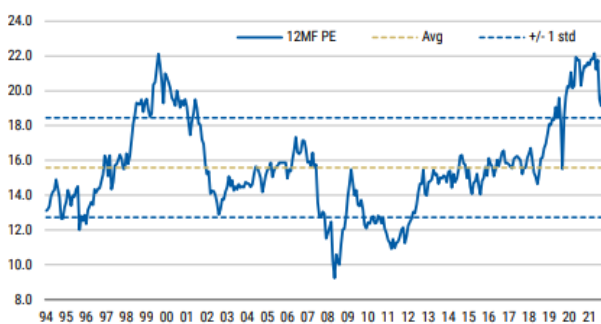


Source: Bloomberg Finance L.P.

The 12-month forward price earnings (PE) of the ASX 200 Industrials Index is currently ~19.5x, down from ~22x, however still well above the long-term average of ~16x.

ASX200 Industrials 12-month forward price earnings (PE)

ASX 200 Industrials – latest 19.5x

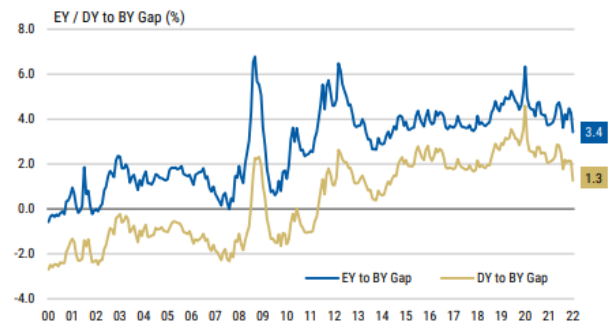


Source: RIMES, IBES, Morgan Stanley Research

Whilst there has been a contraction in the gap between earnings and dividend yields relative to bond yields, equities continue to look attractive relative to alternatives.

ASX200 dividend yield and earnings yield to bond yield gap

ASX 200 12MF earnings and dividend/bond yield gap

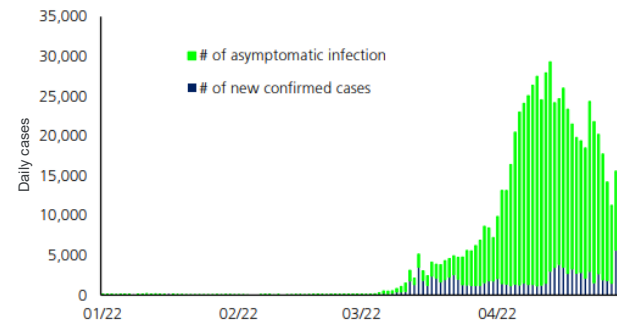


Source: RIMES, IBES, IRESS, Morgan Stanley Research

China update

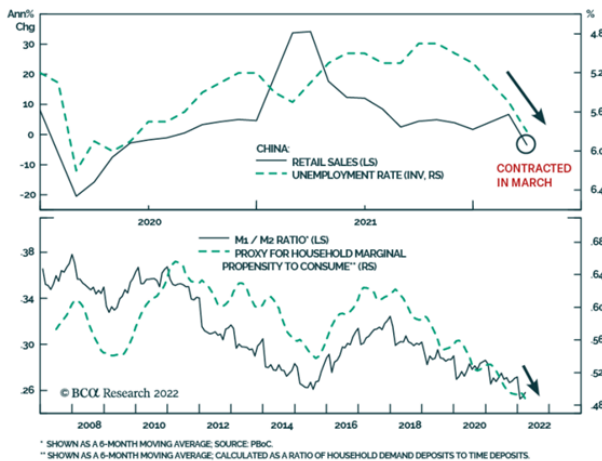
The biggest threat to the near-term outlook has shifted from the Russian war on Ukraine to China. The zero-COVID-19 policy in China is raising the risk of a contraction in Chinese output and is also sending a shockwave through global supply chains. While COVID-19 cases appear to be peaking, vaccination rates are not as high in China as many Western countries and their vaccine has been less effective. This raises the question as to when they will return to normality? While we do not have a definitive answer to this question, we suspect that any weakness due to concerns regarding the lockdown will likely represent a buying opportunity.

COVID-19 Omicron variant appears to be peaking in China



Source: CEIC, UBS estimates

Complicating discussions regarding China is the fact China has been slowing for a while. The chart below highlights tightening liquidity has contributed to a reduction in the desire to consume which has fed into slowing retail sales and unemployment. China has been attempting to rebalance the economy away from speculative housing development but these attempts have begun to be a little too successful causing distress in property markets and a slowdown in gross domestic product (GDP).



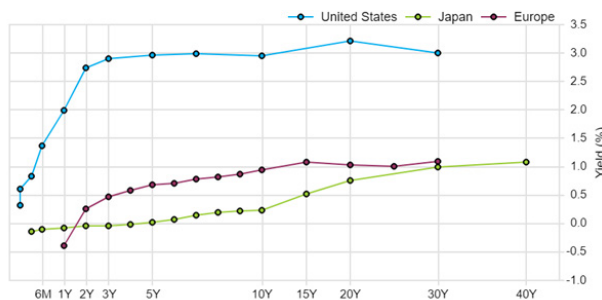
Source: BCA Research

Comments from the Chinese Politburo – led by President Xi Jinping – signalled a change in policy priorities. “Covid must be contained and the economy must be stabilized” and “We should waste no time in planning more policy tools and enhance the strength of adjustment in due course.” Authorities should “strive to achieve full year economic and social development goals” the Politburo said. While no detail was provided here, it is worth remembering that the Politburo’s meetings usually set the tone for official policy and highlight any major adjustments, which are then followed up with specific steps outlined by various government agencies.

Interest rates and inflation

Interest rate expectations have continued to rise following a series of strong inflation numbers across the globe. Inflation is being driven by a range of factors including COVID-19 disruption to supply, de-globalisation as countries seek to secure supply of commodities and supply chains, and fiscal stimulus.

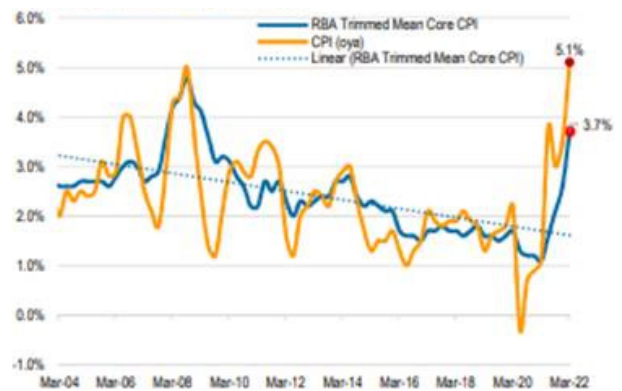
Treasury bond yields in various markets



Source: FactSet

In Australia, the RBA raised the cash rate by 25bp to 35bp, the first rate hike since 2010. The trigger for the hike was the sharp increase in inflation recorded last month, which has picked up more quickly and to a higher level than expected.

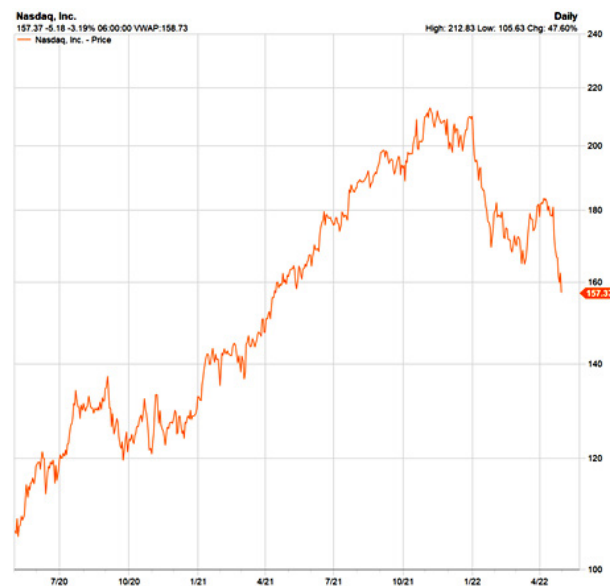
Chart title: Australia | CPI (%oya)



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

The result of higher interest rates has been a fall in growth stocks as noted in the Nasdaq below and rising concerns regarding the risk of recession. Ultimately the goal of higher interest rates is to slow the economy. It would be unusual for the US to move into recession so quickly after the first rate rise, however ultimately a slowdown in the economy should be expected.

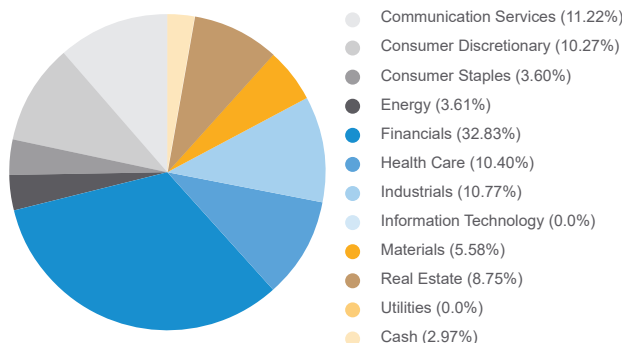
Nasdaq



Source: FactSet

Portfolio attribution

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

| Top 3 contributors | | Alpha* |
|--------------------------------|------------|--------|
| Lendlease | Overweight | 0.39% |
| Block Inc | No Holding | 0.24% |
| Commonwealth Bank of Australia | No Holding | 0.24% |

| Top 3 detractors | | Alpha* |
|------------------|------------|--------|
| BHP Group | Overweight | -0.28% |
| Qube Holdings | Overweight | -0.24% |
| IPH | Overweight | -0.19% |

12 month - top contributors and detractors

| Top 3 contributors | | Alpha* |
|--------------------|------------|--------|
| Woodside Petroleum | Overweight | 1.62% |
| Afterpay | No Holding | 0.96% |
| Macquarie Group | Overweight | 0.73% |

| Top 3 detractors | | Alpha* |
|--------------------------------|------------|--------|
| Commonwealth Bank of Australia | No Holding | -1.35% |
| SKYCITY Entertainment Group | Overweight | -1.13% |
| Goodman | No Holding | -0.41% |

* 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:

- Lendlease (LLC):** rallied during the month after a period of underperformance. Management continues to make incremental progress towards their stated 2024 return targets with a sharpened focus on executing the existing development backlog of over \$100bn.
- Block Inc (SQ2, No Holding):** Square underperformed during the period in line with the broader global technology sector, with rising bond yields disproportionately impacting higher growth companies with limited profitability.
- Commonwealth Bank of Australia (CBA, No Holding):** a pullback in bank stocks following a strong run post the February result.

The top stock detractors for the month were:

- BHP Group (BHP):** underperformed over the month as China COVID-19 lockdowns weighed on 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.
- Qube Holdings (QUB):** Australian container volumes declined -2.5% y/y in 3Q22, However, much of the moderation in volume growth comes from cycling of peak base periods as retailer inventory stocking begins to slow. The market has also been concerned about lockdowns in China and the impact on Shanghai port activity.
- IPH (IPH):** no new news this month. The stock is vulnerable to a higher AUD relative to the USD. A 1c rise in AUD/USD lowers revenue by ~\$2m (and vice versa).

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.

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.

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 (eg 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 (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 4.8% (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 4.3% compared to the benchmark at 3.7%.
 - 2-year forward earnings growth and dividend growth expectations are in line with market growth rates at ~9% and ~8% respectively
- Despite having stronger growth and quality characteristics relative to the market, the valuation is more attractive:
 - 2-year forward price earnings (PE) is at 15.6x compared to 18x for the benchmark.
- In addition, despite the superior growth outlook, the defensive attributes of the Fund have been maintained:
 - 2-year forward free cash flow yield is 5.6% 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 April.

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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