

# DNR Capital Australian Equities Income Portfolio

## Performance Report November 2022

### Performance

The DNR Capital Australian Equities Income Portfolio underperformed the S&P/ASX 200 Industrials Accumulation Index by 0.51% in November. The Portfolio's dividend yield expectation for 2022 is currently 4.46% (6.03% grossed up for franking credits).

### Gross active return as at 30 November 2022

	1mth %	3mth %	1yr %	3yr p.a. %	5yr p.a. %	7yr p.a. %	10yr p.a. %	Incep.* p.a. %
Income Portfolio	3.25	3.49	7.00	8.24	9.54	9.60	12.43	8.33
S&P/ASX 200 Industrials Accumulation Index	3.76	3.33	-1.91	3.56	6.26	7.24	9.51	5.69
<b>Excess return</b>	<b>-0.51</b>	<b>0.16</b>	<b>8.91</b>	<b>4.68</b>	<b>3.28</b>	<b>2.36</b>	<b>2.92</b>	<b>2.64</b>
<b>Income Portfolio dividend yield incl. franking credits<sup>1</sup></b>	<b>0.77</b>	<b>1.68</b>	<b>6.12</b>	<b>5.49</b>	<b>6.49</b>	<b>6.88</b>	<b>9.13</b>	<b>7.18</b>
Franking %	89.2	88.2	81.8	76.1	75.7	74.0	73.3	71.7

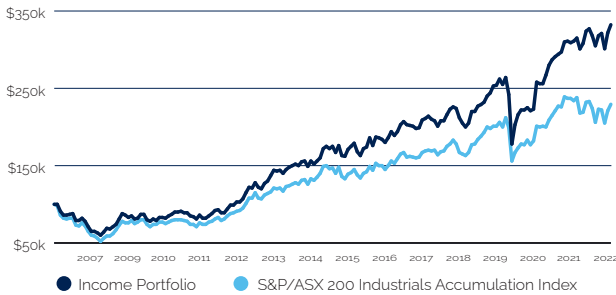
\*Inception date—December 2007.

Source: DNR Capital

<sup>1</sup> 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).

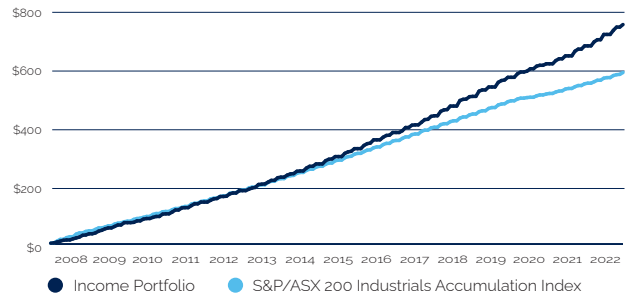
Performance data relates to the DNR Capital model Portfolio. Performance of an investment in this model portfolio through a Portfolio Service may have different performance to the performance in this monthly update as a result of different policies and procedures at different Portfolio Service operators.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



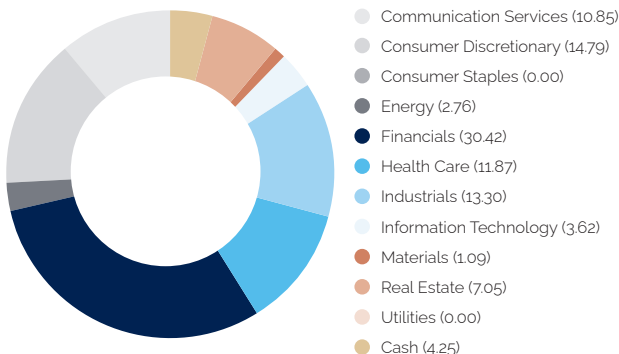
Source: DNR Capital

### Accumulated income from \$1,000 since inception



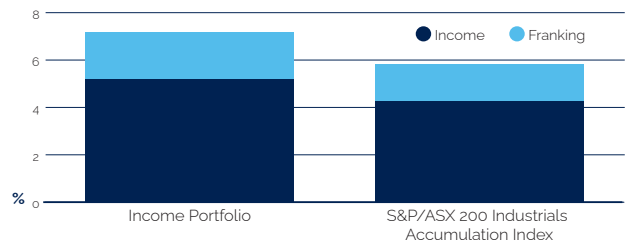
Source: DNR Capital

### Sector weightings %



Source: DNR Capital

### Income yield incl. franking credits since inception



Source: DNR Capital

### Experienced portfolio managers



## Top 5 active holdings

### Security details

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 The Lottery Corporation (TLC)
 

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 QBE Insurance Group (QBE)
 

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 Scentre (SCG)
 

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 Suncorp Group (SUN)
 

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 Qube Holdings (QUB)
 

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## Monthly top contributors and detractors

### Top 3 contributors

		Alpha*
James Hardie Industries	No Holding	0.18%
Computershare	Overweight	0.16%
The Lottery Corporation	Overweight	0.15%

### Top 3 detractors

Lendlease	Overweight	-0.41%
IPH	Overweight	-0.31%
Origin Energy	No Holding	-0.24%

\* 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

- **James Hardie Industries (JHX, no holding):** sold off following a material downgrade to guidance driven by a sharp slowdown in US housing activity. Higher interest rates and a broader economic slowdown continue to point to an ongoing reduction in activity.
- **Computershare (CPU):** outperformed during the month following an AGM update where earnings guidance for FY23 drove a more than 20% EPS upgrade, despite a downgrade to non-margin income businesses. The group is well positioned with diversified recurring revenues and ongoing benefit to flow from the integration Wells Fargo's Trust acquisition.
- **The Lottery Corporation (TLC):** outperformed over the month after reporting continued strong trading in the lotteries business. Volumes will fluctuate with jackpot sequences however underlying trends should support continued solid growth.

### Detractors

- **Lendlease (LLC):** underperformed over the month after reporting softer than expected guidance for the first half of FY23. The softer outlook has been driven by economic volatility which has slowed the delivery of development projects. The company remains confident of development production reaching \$8bn by FY24.

- **IPH (IPH):** underperformed this month due to its defensive characteristics (relative to the risk-on trade in markets) and its US\$ exposure (as the A\$ strengthened).
- **Origin Energy (ORG, no holding):** on 11 November 2022, ORG received an indicative takeover offer from a Brookfield-led consortium with a value of \$9 / share, representing a ~55% premium to the closing price. The transaction is subject to ACCC and FIRB approval.

## Portfolio and market review

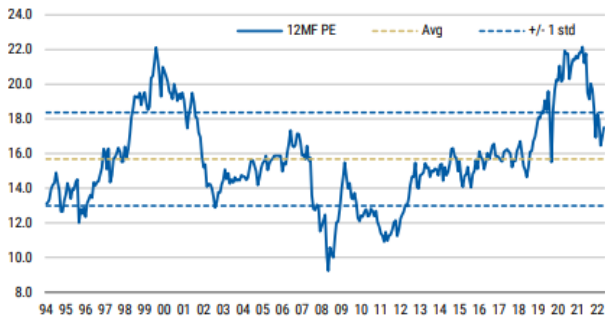
The S&P/ASX 200 Industrials Accumulation Index was up 3.76% during the period. Utilities (+20.9%) was the best performing sector, following a private equity takeover bid for Origin Energy (ORG +41.1%), which also helped peer AGL Energy (AGL +16.9%). Health Care (+6.0%) also outperformed, with sector giant CSL (+7.0%) benefitting from the improved outlook for lower terminal bond rates. Financials (+1.1%) was the worst performing sector, with two of the four big banks weaker on a slowing housing market (CBA +3.0%, NAB -0.3%, WBC +1.2%, ANZ -0.3%). Communications (+2.1%) also underperformed, with defensive telcos Telstra Corporation (TLS +1.5%) and TPG Telecom (TPG -0.2%) left behind in the risk-on rally.

Equities had a strong month in November, as the market pondered that the Federal Reserve (the Fed) may begin slowing rate hikes as soon as December. The S&P/ASX 200 Industrials Accumulation Index (the strategy's benchmark) was up 3.76% over the month, as investors responded to a dovish RBA. The S&P/ASX 200 Industrials Accumulation Index is now up 8.16% since the October low and down 3.68% year to date. This performance is quite remarkable and despite war, inflation, recession risk, China's zero-COVID policy and volatility in markets.

Economic activity has moderated further, particularly in the housing sector but inflation remains high and potentially sticky. The labour market remains tight but leading indicators of labour demand are starting to soften. While wage growth is starting to accelerate, rising by 1% in the September quarter, to be 3% higher over the year. The Reserve Bank of Australia delivered a 0.25% rate hike in early November, taking the cash rate to 2.85%, which it regards as mildly restrictive.

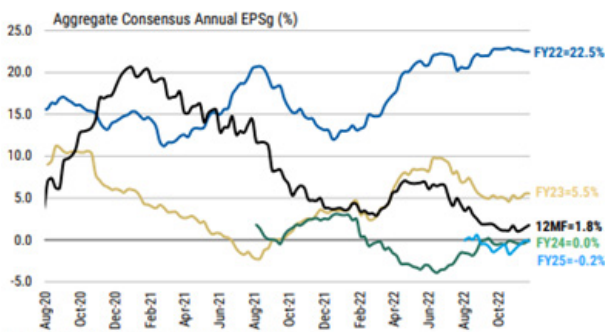
As we have discussed previously, the S&P ASX200 Industrials Accumulation Index valuation multiple has largely corrected from elevated levels, albeit is still above long-term averages. However, if a recession is to transpire in FY23/24, earnings still have a long way to fall. There were only modest earnings revisions over the last month, with consensus revised 2% lower in FY23/24 estimates. Typical recessions see earnings fall 20% on average.

**Exhibit 74: ASX 200 Industrials 12mf Price-to-Earnings (Latest = 17.5x)**



Source: RIMES, IBES, Morgan Stanley Research. As at November 30, 2022

**Exhibit 95: FY22-25 annual aggregate consensus EPS growth trends**



Source: RIMES, IBES, Morgan Stanley Research. As at November 24, 2022

**Franking reform update**

The Labor government continues to reform Australia's franking regime. In September, Treasury drafted a policy to stop companies from paying fully franked dividends when it was being funded by a capital raising. This policy is still under review. Then in October's federal budget, the government specifically targeted the tax treatment of on and off-market share buybacks and selective share cancellations. Draft legislation was released during the last week of November that effectively aligns the tax treatment of off-market share buybacks with on-market share buybacks.

Labor's policies are designed to significantly reduce the appeal of undertaking an off-market buyback and raising capital to fund the payment of dividends. In short, this limits the methods companies use to pass franking credits through to investors. There were initial fears that Labor's franking reform was going to be grandfathered as far back as 2016. Importantly however, these changes will not be applied retrospectively.

Based on Treasury's estimates, the change will increase receipts by \$550m over the four years from 2022-23. In our view, those who will be most affected by these changes are self-funded retirees and retail investors – those investors with low and marginal tax rates. For companies under the new scheme, there is an increased risk that franking credits will become permanently trapped within companies. There are also broader implications for the economy upon which Australia's franking regime has supported investment and growth.

Certainly, the proposed changes reduce the effectiveness of Australia's franking regime. Transparency has been very poor, and we believe there are legitimate concerns that the proposed changes could be just the beginning of broader changes under Labor. Labor believes its proposal closes a loophole to align the corporate tax treatment of on and off-market share buybacks. And they have pledged the franking credit system is "here to stay". If you take Labor at their word, low-tax paying investors will still benefit from the franking regime, which will continue to enhance after-tax returns through fully franked dividends and special dividends.

We expect franking-rich companies to review and possibly increase dividend payout ratios and pay special dividends more regularly. At DNR Capital, our Portfolio/Fund investment strategy considers after-tax income and after-tax returns as part of our investment process and stock selection. We still expect there to be opportunities for investors to target companies delivering sustainable and growing tax-effective income over time.

**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.

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