Australian Equities Socially Responsible Portfolio

Performance Report – November 2017

Market overview and portfolio performance

Equities continued to make gains in November. The US S&P 500 benefited from a solid reporting season but more importantly, hopes for tax reform to pass Congress. The S&P/ASX 200 Accumulation Index closed up 1.64%. A-REITs, Energy and Consumer Staples outperformed while Telecommunications, Financials and Consumer Discretionary underperformed. On the last day of the month banking stocks came under pressure as Prime Minister Malcolm Turnbull ordered a royal commission into alleged 'misconduct in the banking, superannuation and financial services industry'.

The DNR Capital Australian Equities Socially Responsible Portfolio underperformed its benchmark by 0.74%

Portfolio overview

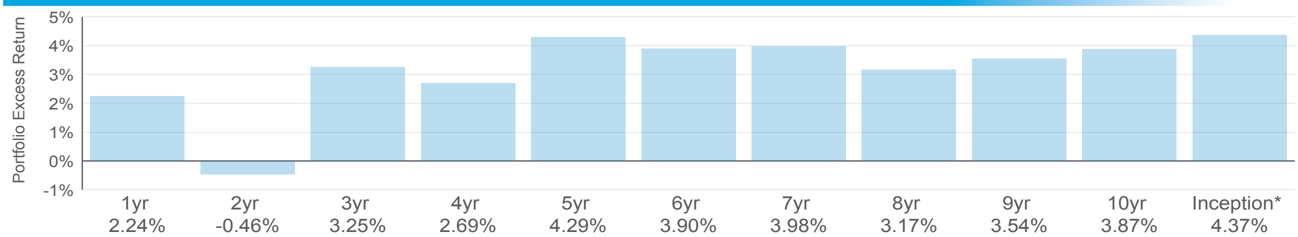
Investment bias	Style neutral
Designed for	Investors who want a competitive return but do not want investments judged to have involvement in gaming, pornography, armaments and tobacco
Benchmark	S&P/ASX 200 Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Accumulation Index by 4% p.a. (before fees) over a rolling three year period
Investable universe	ASX listed securities with a focus on the S&P/ASX 200
Number of stocks	15–30
Asset allocation	Australian equities 80–100% Cash 0–20%
Stock limit	15% maximum weighting
Investment timeframe	5 years
Portfolio managers	Jamie Nicol (Chief Investment Officer) Scott Bender (Portfolio Manager)
Certifications	Certified by RIAA (Responsible Investment Association Australasia)—Responsible Investment Certification Program

Gross active return

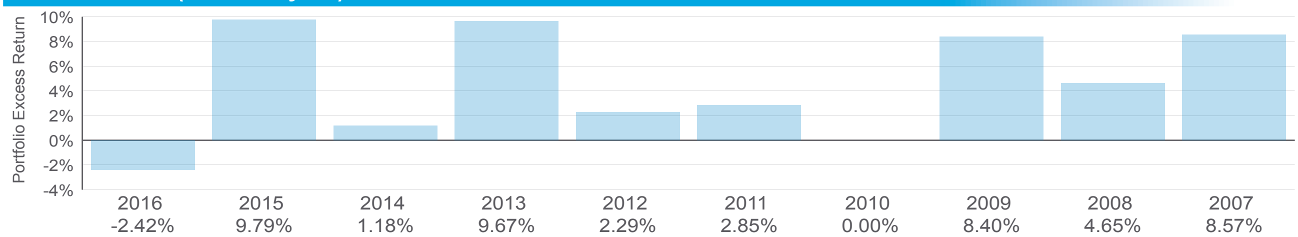
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Socially Responsible Portfolio	0.90	8.13	8.47	16.85	11.97	14.85	12.58	7.53	10.55
S&P/ASX 200 Accumulation Index	1.64	5.71	6.63	14.61	8.72	10.56	8.60	3.66	6.18
Excess Return	**-0.74**	**2.42**	**1.84**	**2.24**	**3.25**	**4.29**	**3.98**	**3.87**	**4.37**

** Inception date—June 2006*

Annualised excess return



Excess return (calendar year)

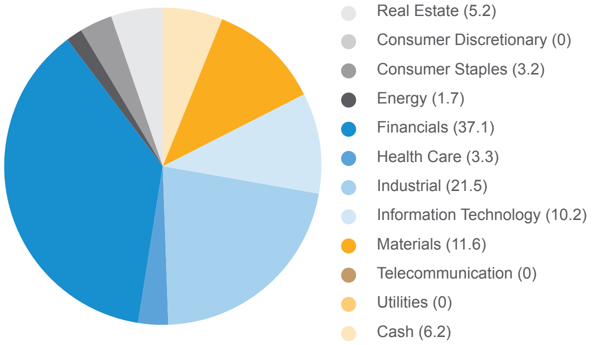


Source: DNR Capital

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.

Sector weightings %



Source: DNR Capital

12 month - top contributors and detractors

Top 5 contributors		Alpha*
BWX	Overweight	1.64%
Telstra Corporation	No Holding	1.64%
Netwealth Group	Overweight	1.41%
Janus Henderson Group	Overweight	0.79%
REA Group	Overweight	0.67%
Top 5 detractors		
Brambles	Overweight	-1.06%
CSL	No Holding	-1.02%
Healthscope	Overweight	-0.99%
IRESS	Overweight	-0.41%
Cash	Overweight	-0.38%

Monthly - top contributors and detractors

Top 5 contributors		Alpha*
Janus Henderson Group	Overweight	0.31%
Brambles	Overweight	0.29%
ANZ Banking Group	No Holding	0.24%
REA Group	Overweight	0.23%
Telstra Corporation	No Holding	0.13%
Top 5 detractors		
ALS	Overweight	-0.43%
National Australia Bank	Overweight	-0.42%
BWX	Overweight	-0.34%
IPH	Overweight	-0.29%
MYOB Group	Overweight	-0.28%

** 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.*

Portfolio attribution

The top stock contributors were:

- Janus Henderson Group (ASX:JHG)—Reported 3Q17 results that showed strong investment performance across all time periods with net inflows of US$0.7b. Pleasingly, the company increased its cost synergy run rate to at least US$125m, up from US$110m.
- Brambles (ASX: BXB)—The company's 1Q18 sales trading update was slightly better than expected (6% sales growth). CHEP Americas results were pleasing with the US pallet-pooling business revenue growing by 4%, comprising 3% from net new business wins and 1% from organic volumes.
- Australia and New Zealand Banking Group (ASX:ANZ, no holding)—Lagged peer earnings' growth both in business banking and institutional banking and, to a lesser extent, in New Zealand. It also lagged in terms of net interest margin trends, notwithstanding ongoing portfolio rebalancing.

The top stock detractors were:

- ALS (ASX:ALQ)—Reported a 1H result for the six months ended 30 September, in which net profit was at the low end of the company's previously issued guidance. Additionally, the FY18 net profit guidance of $135–145m was below consensus expectations. ALQ shares fell 7.4% on the first trading day following the announcement.
- National Australia Bank (ASX:NAB)—Reported a full-year result for the year ended 30 September which was in line with expectations. However, the focus was on the announcement of an 'ambitious and necessary' restructuring, which would see FY18 expenses increase by 5–8% due to higher investment spend. NAB shares fell 2.8% on the day of announcement.
- BWX (ASX:BWX)—Shares consolidated during the month after posting a 26% return the prior month. BWX has been active in acquiring new brands and opening up further growth opportunities in the US.

Market review

The market has enjoyed a strong run over the last quarter as a pick-up in global growth and a lack of alternative investments has encouraged further interest in equities. With the market rising 6% over the quarter to the end of November, we discuss key investment questions for consideration as we head towards the end of the year.

Can the run in high price to earnings ratio (PE) growth stocks continue?

The PE of the market remains broadly in line with its recent rating despite the strong run.

A basket of growth stocks has offered significant returns this year. Strong momentum in these stocks can be attributed to a solid growth outlook and sound business models in a market where disruption to larger companies like Telstra Corporation (ASX:TLS) and the banks' limit alternatives for investors. These stocks are operating in healthcare, technology and in export sectors. A key question is whether valuations will act as a constraining factor for these companies, or whether superior growth will allow them to grow into their valuations. While we remain attracted to a number of the business models in this basket, we have been a little more cautious of late considering the strong momentum these companies have enjoyed.

Of particular note is the PE dispersion of the market which highlights the gap between the highest PE stocks and the lowest. This has recovered back to high levels which further demonstrates the momentum in these growth stocks.

Will inflation bite?

10-year bonds have steadily fallen over past decades but have found some support at current levels. Should evidence of inflation emerge then we would expect to see these rates increase, which would impact valuations especially for market sectors that are highly correlated to bond yields like telecommunications, utilities, property trusts and infrastructure.

We are seeing capacity tighten in the US and growth pick up across the globe, which should tighten inflation over time. The political environment is further feeding into this pressure. The electorate is polarising from extreme right to extreme left, which raises the potential for policy missteps as populist politicians seek to appease the electorate.

Will the acceleration in global growth feed into earnings?

Global growth has accelerated over the past year, with European and US manufacturing indices rising strongly. This is feeding into higher capex and lower unemployment, which starts to feed into a sustainable recovery. Importantly for Australia, this results in higher commodity prices and offers a pick-up in resource-related capex. The mining sector has been raising capital and repaying debt, which leaves it well placed to increase capex.

Furthermore, oil and gas capex has fallen sharply in recent years. The market is generally forecasting a modest pick-up from here that will ultimately limit capacity, drive prices and encourage further spending. We think the risk in the medium-term is to the upside. We have identified opportunities like WorleyParsons (ASX:WOR) and ALS (ASX:ALQ), as well major resource companies that will benefit from a pick-up in resource-related spending.

The strength of the US economy and moderate signs of a potential pick-up in wage inflation should support globally exposed companies like Brambles (ASX:BXB).

Will Australian economic recovery follow the rest of the world?

Australia has lagged the global economic recovery after largely avoiding the worst of the GFC. We view Australia's economic performance favourably, given that the collapse in mining capex and the collapse in the terms of trade would usually be associated with a recession. However, the flexibility of a floating dollar enabled a resurgence in the export sector including education and tourism, and a booming housing market provided jobs in construction. Government spending on infrastructure is now having effect and mining investment is returning at a time when the housing market is slowing. The consumer remains fragile, but the jobs market is healthy (with higher income jobs returning). If the housing downturn is not too deep, then there is potential for the Australian economy to surprise on the upside.

How will banks weather a royal commission?

The Australian Government has announced a royal commission into misconduct in the banking, superannuation and the financial services industry. It appears the Turnbull government and the major banks have worked closely to establish the review, given mounting political pressure and ongoing community concerns.

The scope of the royal commission is very broad, backward looking and primarily focused on misconduct, or where community standards have not been met. The terms of reference under this government are likely to be more constructive with a focus on consumer and small and medium-sized enterprise customers and offerings. While an interim report is due by September 2018, there is a strong likelihood that the royal commission will extend beyond the February 2019 deadline.

The royal commission is not expected to overlap with any existing inquiry or investigation. Over the past decade, the banking sector has faced the Financial Services Inquiry in 2014 as well as around 50 reviews, with about 10 still ongoing (AUSTRAC/CBA; ASIC/BBSW Rate Rigging; ACCC/Mortgage Pricing Inquiry etc).

We expect that incremental costs associated with the royal commission could be up to ~$1b for the major banks (~20% of FY17 investment spend). Potential fines are difficult to predict and will depend on the outcome of the review, but we expect the costs will ultimately be manageable. Importantly, we believe dividends are sustainable during this period, particularly given the improved capital positions.

We think that the distraction of senior management will be one of the key risks over the next 12–24 months. National Australia Bank (ASX:NAB) and Australia and New Zealand Banking Group (ASX:ANZ) are already undergoing significant organisational restructure and the Commonwealth Bank of Australia (ASX:CBA) is searching for a new CEO.

We believe the banks are trading at fair valuations given the subdued earnings outlook and headwinds from bad debts and regulatory risks. However, an attractive ~6% dividend yield (plus franking benefits) should provide support. We remain underweight the sector.

Disruption and emerging business models

During the discussion on growth stocks, we mentioned the attraction of a range of business models less exposed to disruption.

The media, retail, telecommunications and bank market sectors appear attractive from a valuation perspective, however they are all facing significant structural challenges that could place dividends and capital at risk.

We know that:

- media/broadcasting stocks are facing substantial competition from Facebook, Twitter and Netflix
- retailers await the entry of Amazon
- the telecommunications market faces heightened competition in a post-NBN world along with other technological advances
- banks are facing an over-leveraged consumer, property headwinds, cyclically low bad debts, regulatory/political risks, as well as technological threats.

Given these disruptions, we retain some caution regarding companies exposed to these areas. But the hysteria regarding disruption can present opportunities where we can find companies less exposed, or where we see the fears misplaced. Companies like Aurizon Holdings (ASX:AZJ) and Brambles (ASX:BXB) have faced concerns regarding disruption that have capped their valuations. Despite some market concerns, the outlook appears robust for these companies and as a result, valuations remain attractive.

Portfolio moves

No major changes to the portfolio during November.

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.

Investment strategy

The Australian Equities Socially Responsible Portfolio has an investment style best described as 'style neutral', focusing on environmental, social and governance (ESG) issues.

The security selection process has a strong bottom-up discipline and focuses on buying quality businesses at reasonable prices. We define quality businesses as being those with the following five attributes:

- earnings strength (particularly improving return)
- superior industry position
- a sound balance sheet
- strong management
- low ESG risk.

The Australian Equities Socially Responsible Portfolio incorporates a negative portfolio screen across:

- pornography
- gaming
- armaments
- tobacco.

A positive ESG screen is also used to identify those securities with enhanced ESG policies.

DNR Capital sources ESG-related information from Bloomberg.

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.

CERTIFIED BY RIAA

The DNR Capital Australian Equities Socially Responsible Portfolio has been certified by RIAA according to the strict disclosure practices required under the Responsible Investment Certification Program. See www.responsibleinvestment.org for details.

Office address
Level 22
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