Australian Equities Socially Responsible Portfolio

Performance Report – February 2018

Market overview and portfolio performance

Jamie Nicol
Chief Investment Officer

Scott Bender
Portfolio Manager

February saw a return of volatility after several periods of calm equity performance. The Australian market outperformed its global counterparts in February, helped by a reporting season that saw more companies exceed expectations than miss expectations. The start of February saw heightened volatility with the S&P/ASX 200 falling up to 4.6% between 2 February and 9 February in response to strong hourly earnings in the US, which may put pressure on inflation and result in higher bond yields. Reporting season was well received and saw the S&P/ASX 200 Accumulation Index close up 0.36%.

The DNR Capital Australian Equities Socially Responsible Portfolio underperformed its benchmark for the period by 2.21%. Key stock contributors were Lendlease (ASX:LLC), Telstra Corporation (ASX:TLS, no holding) and Woodside Petroleum (ASX:WPL, no holding). Key stock detractors were BWX (ASX:BWX), IPH (ASX:IPH) and CSL (ASX:CSL, no holding).

Portfolio overview

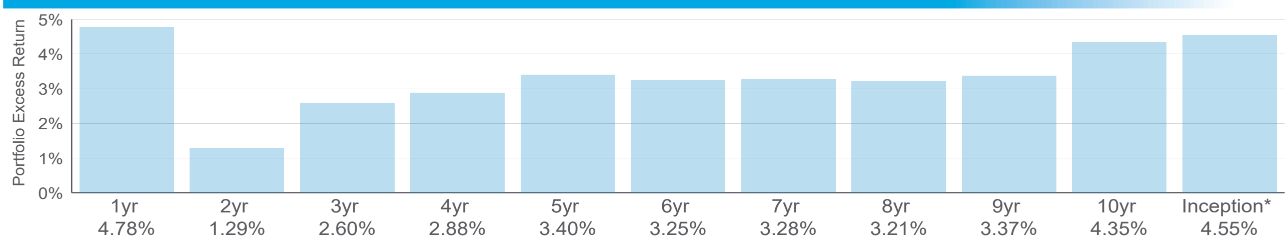
Investment bias	Style neutral
Designed for	Investors who want a competitive return but do not want investments judged to have involvement in gaming, pornography, armaments and tobacco
Benchmark	S&P/ASX 200 Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Accumulation Index by 4% 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
Minimum suggested investment timeframe	5 years
Certifications	Certified by RIAA (Responsible Investment Association Australasia)—Responsible Investment Certification Program

Gross active return

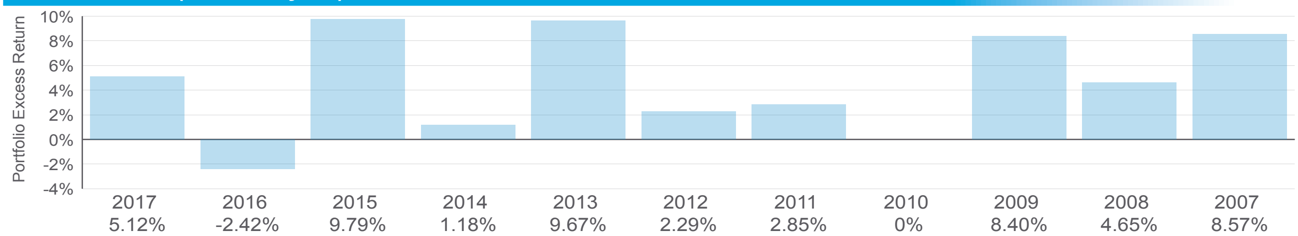
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Socially Responsible Portfolio	-1.85	1.14	9.35	14.88	7.67	11.41	11.21	9.75	10.56
S&P/ASX 200 Accumulation Index	0.36	1.72	7.52	10.10	5.07	8.01	7.93	5.40	6.01
Excess Return	**-2.21**	**-0.58**	**1.83**	**4.78**	**2.60**	**3.40**	**3.28**	**4.35**	**4.55**

** 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.

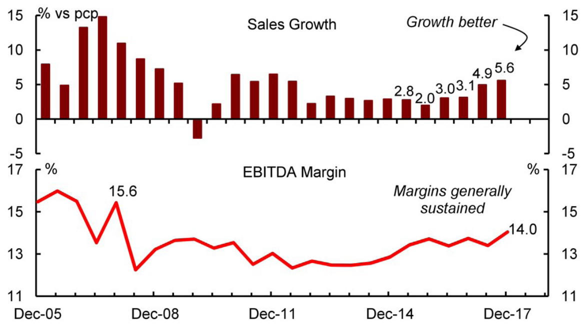
Portfolio review

The portfolio underperformed during reporting season, with a pleasing set of results by the larger positions in the portfolio offset by a couple of disappointments (which resulted in significant market overreactions in our view). The outlook appears reasonably robust given that we were satisfied with the bottom up, and a range of stocks in the portfolio offer good valuation support.

Reporting season

Reporting season was quite a strong one, albeit extremely volatile. Sales growth continued to climb and profit margins are lifting, which is supporting the 6.6% profit growth expected for the year. Offshore companies operating in the US are enjoying some tax relief that has provided further tailwind.

Growth from Australian Companies



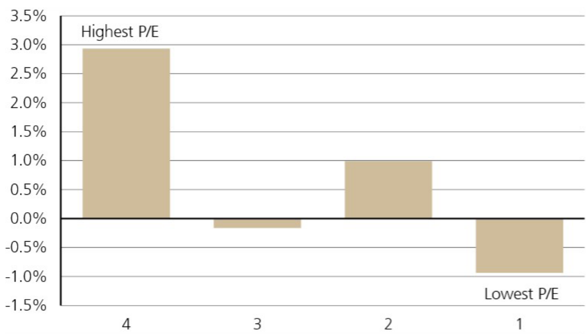
*Source: Company data, Citi Research *Also excludes Telstra Corporation (ASX:TLS)*

Key trends

1. Volatility was high

Momentum was a defining factor in the reporting season, with expensive stocks bid up further on good results. Share prices of The a2 Milk Company (ASX:A2M), CSL (ASX:CSL), ResMed (ASX:RMD), REA Group (ASX:REA) and Treasury Wine Estates (ASX:TWE) rallied as did numerous small cap stocks. However, stocks with small misses reacted sharply. Domino's Pizza Enterprises (ASX:DMP) was hit hard, as were other market darlings like Blackmores (ASX:BKL) and BWX (ASX:BWX). The market reacted more to the higher-rated stocks. It is a momentum-driven market at present, but we are cautious regarding this trend given rising bond yields and have lightened our exposure to some highly rated stocks.

Average excess return on reporting day by PE Quintile (ex-Resource)



Source: UBS, Factset

2. Laggards start to offer value

The cheaper stocks also underperformed, which further highlights the momentum trade in the market. While some of these stocks like Telstra Corporation (ASX:TLS) and retailers face structural issues, other laggards are looking interesting. We used some of the weakness in laggards in our portfolios to top up, especially where we gained confidence in the underlying result.

3. Beats beat misses

There has been a clear trend towards beats relative to misses, albeit not all of these 'beats' have translated to earnings per share (EPS) upgrades. We estimate 33% of large caps have delivered beats, ahead of only 16% delivering misses (just under half of beats have led to significant upgrades).

4. Plenty of significant large cap upgrades (but plenty of downgrades)

For large caps 25% of reporters have seen a consensus upgrade of 3% or greater, while 18% have seen a downgrade of 3% or greater.

5. Resources experienced some cost pressure

Resources disappointed during the month due to rising cost pressures. This bodes well for mining service players as rising commodities is resulting in a pickup in activity. We are also seeing some inflationary pressure emerge, especially for companies exposed to the US, like Brambles (ASX:BXB). We continue to believe a focus on quality will enable those companies with pricing power to pass on inflation to their customers.

6. Retailers struggling

Domestic conditions remain mixed. Housing is rolling over but mining and infrastructure spending is picking up. However, there are headwinds for consumers as mortgages roll from interest only to principal plus interest, and health care, electricity and insurance costs rise. Travel businesses performed exceptionally well in the period as the trend towards spending on experiences remains strong. Traditional retailers remain under pressure.

Best results in the portfolio

Lendlease (ASX:LLC)

Going into the result, there were concerns surrounding some issues Lendlease had with construction projects. However, it positively surprised with 13% earnings before interest, taxes, depreciation and amortisation (EBITDA) growth and the announcement of a buyback. Returns are sitting at 14%, balance sheet is strong, the pipeline of developments ($57b) and construction activity ($22b) is strong, it continues to diversify across geographies and it continues to grow out the higher multiple investments side of the business ($28b in FUM). The outlook remains favourable, with the stock trading on an attractive multiple despite good earnings visibility.

WorleyParsons (ASX:WOR)

WorleyParsons delivered 37% profit growth off a low base as engineering activity begins to recover. The board restored a dividend, which sent a positive signal to the market about the health of the business. The outlook is improving as the strong oil price means oil companies are dusting off capex plans once again. While some uncertainty remains regarding the pace of the recovery, the trajectory looks promising and the company's leverage to this trend is strong. We have added to the position.

Link Administration Holdings (ASX:LNK)

Profits were up 58% with the company benefiting from the synergies from integrating the Superpartners business and from the recent acquisition of Link Asset Services. The new acquisition was the highlight and it appears to have started strongly. The outlook remains robust with further cost savings as a result of the Superpartners integration ($35m) and further benefits from the Link Asset Services acquisition with $25m worth of synergies available. This represents more than 20% of current profits. The market lifted FY18 forecasts by 8% and FY19 by 2%. We added to the position following the result.

Worst results in the portfolio

South32 (ASX:S32)

The S32 result was up 12% on the prior comparative period which was a little better than the market expected. Furthermore, a special dividend was announced that furthered the trend of the stock from a capital management perspective. However, higher costs disappointed and this along with recent production issues raised concerns regarding the quality of the assets. The stock de-rated sharply. We continue to rate management highly, are attracted to the mix of commodities and the balance sheet strength. The position has been a very small one in the portfolio and we added as it sold off.

IPH (ASX:IPH)

IPH earnings were soft with a decline of ~10%, which was below market expectations. While the foreign exchange negative impact was larger than expected, softer patent filing conditions in Australia/New Zealand (A/NZ) were the primary source of the negative surprise. Management pointed to the impact of the introduction of the America Invents Act (which resulted in a higher number of filings in prior periods) and fewer Chinese inbound filings. IPH's competitors have also noted similar trends during the period. In Australia, IPH maintained #1 market share but industry patent volumes were down ~2%. We expect 2H18 and FY19 earnings to improve as the A/NZ business reverts back to growth trends experienced in recent years, Asia volumes pick up (strong Nov, Dec and Jan patent filings up 15% on preceding quarter), new acquisitions (AJ Park and HK/China) contribute a further ~$5m by FY19 (they only contributed ~$1m of EBITDA in 1H18) and losses in the Data Analytics division of $3m are expected to be less in FY19 (with break-even targeted for FY20).

We are of the view that the weakness in Australian patent filings is cyclical and will recover in FY19. IPH is now trading on a valuation of ~12x (FY18 PE) and a 12-month forward dividend yield of >6%, which is attractive. Patience is required, but given the strong balance sheet, strong market position and attractive valuation we increased our exposure to IPH as the share price deteriorated.

BWX (ASX:BWX)

BWX produced a profit result up 30.5% on the prior year and it guided to a result of $43–46m compared to the market, which was at $46.5m. The guidance implies a stronger second half as acquisitions are bedded down, and the Coles Supermarket Australia distribution bites. The 1H18 saw a large investment in television advertising. The slight softness to the guidance and the second half skew caused the market to sell off and give back the gains of the past six months. This appeared overdone with the stock now on FY19 15x earnings, strong brands, strong returns, and a global growth opportunity. Management is buying into the stock, providing further comfort, and we also added to our position.

Risks for the portfolio

The key risk to the portfolio (other than stock-specific risk) will be if the high inflation extends to a sharper market sell off.

Outlook

Valuations are expensive in pockets but the economy looks strong. If inflation does not run away, we think the market will buy the dips and any pull back will be a pure valuation adjustment rather than deterioration in the underlying economy and earnings. Volatility is increasing across the market, which we believe is opening opportunities with some value appearing in oversold stocks. However, some pockets of the market remain overvalued and vulnerable to higher bond rates.

Portfolio positioning

We have been undertaking a range of strategies to protect the portfolio from the risk of rising rates. These include:

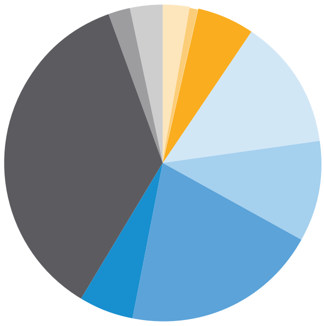
- Being significantly underweight bond proxies.
- Reducing our exposure to high PE quality stocks with many of our positions substantially reduced. This Portfolio will tend to have a reasonable exposure to fast growing companies operating in emerging industries. This can increase volatility in the short term but we would continue to expect to find good companies that drive good returns over time like the recently purchased Nanosonics (ASX:NAN), which has a very large global market opportunity.
- Reducing our exposure to market-exposed stocks.
- Increasing our exposure to those stocks with improving quality characteristics. Many of these companies are exposed to the improving global growth outlook including ALS (ASX:ALQ) as mining exploration activity recovers, and WorleyParsons (ASX:WOR) as oil and gas capex spend increases. Valuations for these types of companies will be supported by rising earnings and have a low correlation to bond yields.
- Increasing our exposure to de-rated quality companies like IPH (ASX:IPH), Healthscope (ASX:HSO), Lendlease (ASX:LLC) and Brambles (ASX:BXB). These companies have suffered over the past year or so but their outlooks remain robust (Healthscope is undertaking a major portfolio review, Lendlease despite a hiccup is exposed to infrastructure spend and Brambles is winning business after a small stumble). Quality companies can pass on inflation to their customers and those that have de-rated have greater valuation support than many of the highly fancied companies in the market.
- Managing quality stocks that tend to have lower debt levels relative to the market and earnings will not be as exposed to rising debt levels.

Portfolio moves

No major changes to the portfolio during February.

Portfolio attribution

Sector weightings %



Source: DNR Capital

12 month - top contributors and detractors

Top 5 contributors		Alpha*
Aconex	Overweight	1.52%
Telstra Corporation	No Holding	1.18%
Janus Henderson Group	Overweight	0.95%
SEEK	Overweight	0.78%
Lendlease	Overweight	0.78%
Top 5 detractors		
CSL	No Holding	-1.04%
Healthscope	Overweight	-0.95%
Aurizon Holdings	Overweight	-0.55%
IPH	Overweight	-0.50%
QBE Insurance Group	Overweight	-0.48%

Monthly - top contributors and detractors

Top 5 contributors		Alpha*
Lendlease	Overweight	0.66%
Telstra Corporation	No Holding	0.16%
Woodside Petroleum	No Holding	0.16%
National Australia Bank	Overweight	0.14%
WorleyParsons	Overweight	0.14%
Top 5 detractors		
BWX	Overweight	-1.21%
IPH	Overweight	-1.15%
CSL	No Holding	-0.46%
Janus Henderson Group	Overweight	-0.35%
IRESS	Overweight	-0.26%

** 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.*

The top stock contributors were:

- Lendlease (ASX:LLC)— Reported a solid 1H18 result. EBITDA increased 13% to A$721m, with a greater-than-expected engineering impairment more than offset by retirement and military housing revaluations, and solid Barangaroo leasing outcomes lifting the final sale price. Lendlease completed 1,189 apartments in the half with 883 Collins Street and Darling House being the main contributors. Lendlease also announced it will return A$500m of excess capital by way of on market buy-back.
- Telstra Corporation (ASX:TLS, no holding)—Reported adjusted 1H18 EBITDA +2% to A$5.47b in what was a somewhat mixed result, with a solid performance from the ex-NBN businesses, strong subscriber growth and an accelerating rate of cost out. Offsetting this was the increased level of debt on the balance sheet and the softer-than-expected fixed line performance.
- Woodside Petroleum (ASX:WPL)—CY17 financial results have been overshadowed by two surprise announcements: a US$744m acquisition of ExxonMobil's 50% interest, and a A$2.5b rights issue to fund investments this year. While the acquisition is in keeping with WPL's M&A policy (of sub-US$1b bolt-on targets), with Scarborough not in production for a number of years the market reacted unfavourably to the news (particularly given that it comes with a large raising).

The top stock detractors were:

- BWX (ASX:BWX)—Delivered a 1H18 result and FY18 guidance that disappointed the market. We have used the share price weakness as an opportunity to build our position as the shares are attractively priced at FY19 PE of ~15x. The long term story for Sukin remains compelling as it grows offshore and integrates new brands. We are encouraged by the CEO and CFO investing in the company.
- IPH (ASX:IPH)—Reported 1H18 earnings. Revenue was up 9% to $101.2m but underlying EBITDA was down 3% to $33.2m. Overall the result was softer than expected, reflecting softer patent applications.
- CSL (ASX:CSL)—Underlying net profit after tax (NPAT) of US$1,052m was driven by stronger-than-expected revenue growth for IG, haemophilia, and Seqirus and the company upgraded goals for FY18.

DNRCapital

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.

Disclaimer

This document has been prepared by DNR Capital Pty Ltd, AFS Representative - 294844 of DNR AFSL Pty Ltd ABN 39 118 946 400, AFSL 301658. It is general information only and is not intended to be a recommendation to invest in any product or financial service mentioned above. Whilst DNR Capital has used its best endeavours to ensure the information within this document is accurate it cannot be relied upon in any way and you must make your own enquiries concerning the accuracy of the information within. The information in this document has been prepared for general purposes and does not take into account the investment objectives, financial situation or needs of any particular person nor does the information constitute investment advice. Before making any financial investment decisions you should obtain legal and taxation advice appropriate to your particular needs. Investment in a DNR Capital managed account can only be made on completion of all the required documentation. DNR Capital does not guarantee the repayment of capital from the portfolio or the investment performance of the portfolio.

If you have invested in the Australian Equities Socially Responsible Portfolio via a service such as investor directed portfolio service, managed account service or separately managed account ('Portfolio Service'), you can obtain information from the Portfolio Service operator. If you invest via a Portfolio Service, different terms may apply to your investment. You should read the disclosure document for that Portfolio Service and consider your circumstances prior to investing.

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

DNRSRII.4.07.1802