Australian Equities Socially Responsible Portfolio

Performance Report – May 2018

Market overview and portfolio performance

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May is historically a difficult month for the Australian equity market but this year it managed to produce a positive return despite Italian elections causing concerns towards the end of the month. Protectionist policies were a key focus during the month, with US President Trump investigating vehicle imports and announcing tariffs on aluminium and steel imports from Canada, Mexico and the European Union (EU). Trade fears did ease as the US and China released a joint statement in which China agreed to increase imports from the US in a diplomatic effort to reduce its trade deficit with the US. The S&P/ASX 200 Accumulation Index closed up 1.09%.

The DNR Capital Australian Equities Socially Responsible Portfolio outperformed its benchmark for the period.

Portfolio overview

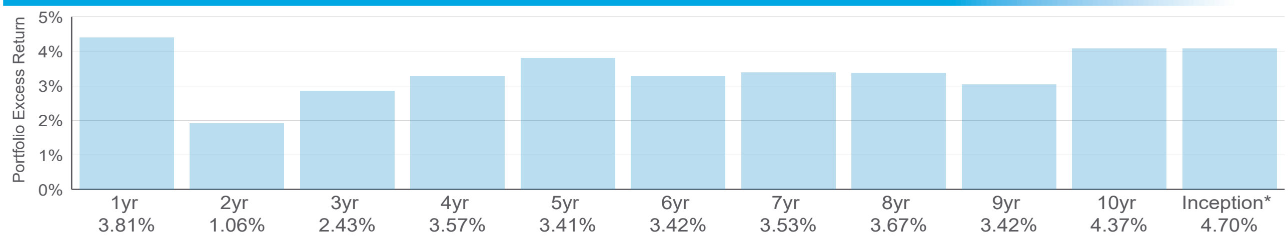
Investment bias	Style neutral
Designed for	Investors who want a competitive return but do not want investments judged to have involvement in gaming, pornography, armaments and tobacco
Benchmark	S&P/ASX 200 Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Accumulation Index by 4% 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

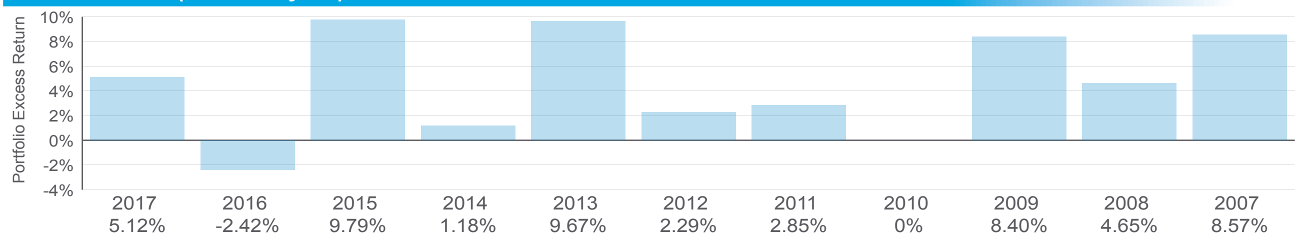
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Socially Responsible Portfolio	1.43	3.40	4.57	13.44	8.37	12.17	11.87	9.61	10.83
S&P/ASX 200 Accumulation Index	1.09	1.08	2.81	9.63	5.94	8.76	8.34	5.24	6.13
Excess Return	**0.34**	**2.32**	**1.76**	**3.81**	**2.43**	**3.41**	**3.53**	**4.37**	**4.70**

** 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

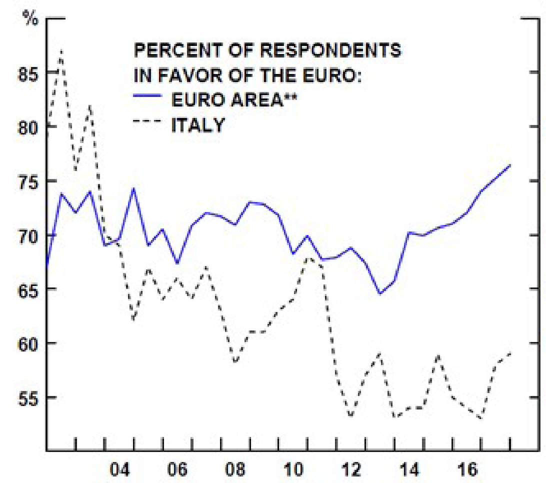
While most markets ended the month up in absolute terms, May saw geopolitical risks once again bubble to the surface. The roundabout of Italian politics looks set to continue with the interim government on shaky ground, while global trade tensions continue to rise. This month we will explore these issues in more detail and spend some time discussing the risk that a tighter lending environment, inspired by the Royal Commission, could lead to a domestic 'credit crunch'.

Italian politics

Italian politics is convoluted, complicated and always evolving. During May, President Mattarella rejected the Conte government's appointment of Savona (a well-known Eurosceptic) as finance minister and gave a mandate to Cottarelli (a former IMF director) to head up an interim government. In the likely event that Cottarelli does not win confidence, elections will be held after August or by early 2019 at the latest.

Six prime ministers in six years would suggest that the next election will be unlikely to solve what seems to be the ever turning, revolving door of Italian politics. The more relevant issue is the impact that the outcome of the election will have on Italy's position in the EU. While support for EU membership remains above 50%, it is important to consider the underlying drivers of anti-EU sentiment.

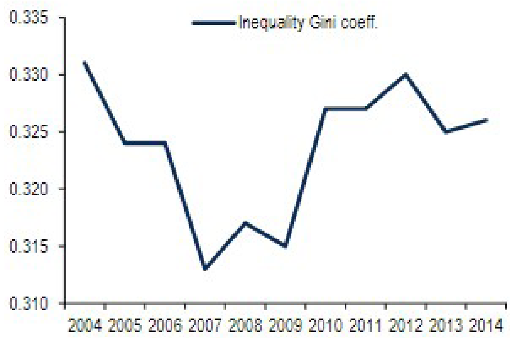
Italian voter support for euro



Source: BCA Research

The common narrative among EU sceptics is that the euro worked solely for core countries by protecting Germany against currency appreciation. Meanwhile, more fragile southern European countries were unable to periodically 'reset' their competitiveness with devaluations of their own currencies. The situation has been exacerbated by the fact that income inequality, measured by the Gini coefficient, has been rising on trend.

Organisation of Economic Co-operation and Development (OECD) Gini coefficient



Source: OECD, BofA Merrill Lynch Global Research

The most obvious consequence of the Italian political crisis is that it continues to focus attention on the shortcomings of the monetary union. That said, any institutional road to a formal Italian exit (Italexit) looks particularity difficult with both a parliamentary vote and presidential approval required. A Brexit-style referendum is not possible under the current constitution, so calling a referendum on Italexit would first require a change of the constitution and that in turn would require both a double vote by the parliament and a public referendum. The constitutional complexity and the uncertain impact of unravelling a monetary union would make it difficult for Italy to exit the EU, especially when the majority of Italian voters still support EU membership.

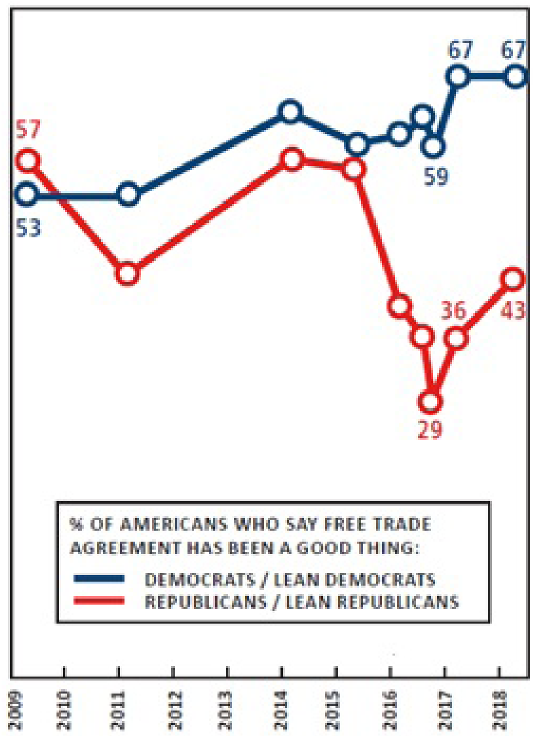
The volatile political situation is leading to more conservative positioning in financial markets. We have already seen money flowing into US treasuries with the US 10-year bond yield falling back under 3%. The sustainability of the move will depend on near-term news flow, however the longer-term outlook for bonds remains clouded by the prospect of a continued firming of inflationary indicators. We remain cautious on the outlook for bonds and bond proxies (i.e. utilities, infrastructure and REITs). Short-term political machinations might see bonds rally, but we would need to see a material shift in the underlying economic drivers to become more constructive on bonds.

Trade wars

The US-China trade dispute appeared to make some progress during May. As is often the case with the Trump administration, details were vague. An official White House statement claimed 'there was a consensus' regarding a substantive, but unquantifiable, reduction in the US trade deficit. China agreed to 'meaningfully' increase its imports of US agricultural and energy products, which are both relatively low-value-added exports. China went on to agree to 'encourage the expanded trade in manufactured goods and services'. Overall, the announcements were very light on detail and had possibly more to do with the Trump administration looking for a positive news story rather than real reform.

Interestingly, support for free trade has been firming, especially among Republicans. However, given the political nature of global trade, we struggle to see any real easing of trade tension in the near term. While a full-blown trade war would not be in any parties' interest, we are potentially seeing trade being used as a political tool at a more granular level. In recent months China has been more proactively displaying its 'disappointment' with Australia's stance on the South China Sea dispute. As well as several negatively framed articles in the China Daily, some Australian exporters have seen processing times for shipments slow in recent months. Official explanations revolve around technical requirements (i.e. incorrect labelling), however China has been known to implement unofficial trade restrictions to exert political influence in the past. Chinese media has mentioned both Australian wine and beef products as potentially at risk. Historically such minor 'disputes' have been short lived, but we remain conscious of the potential oversized impact these events might have on particular sectors and businesses.

Support for free trade recovering, but Republicans still trail Democrats



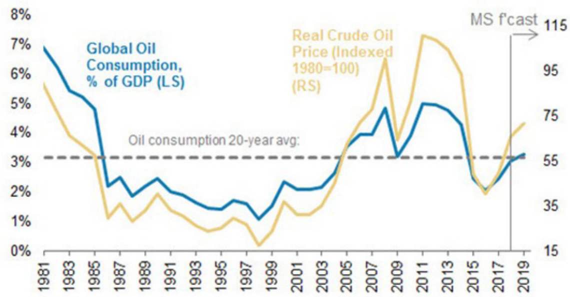
Source: Pew Research

Oil price hits a three-year high

The month of May saw oil extend on recent gains with Brent crude oil trading above $80 during the month. The extent of the gains has sparked some debate on whether this poses a risk to the recovery in global growth.

One way to assess the impact of oil on the global economy is to look at the trend in the 'oil burden'. Oil burden measures the value of oil consumed compared to gross domestic product (GDP). Morgan Stanley has estimated the projected rise in oil demand and prices and calculated that the global oil burden will rise to 3.1% of GDP in 2018 from 2.4% in 2017. While above long-term averages, the oil burden sits roughly in line with the 20-year average and the global economy should be able to absorb the moderate step up.

Global oil burden rising, but not at burdensome levels yet



Source: BP, Haver Analytics, Morgan Stanley Research forecasts

A domestic credit crunch?

The Royal Commission has provided plenty of attention-grabbing headlines. The highlighted cases of irresponsible lending are likely to drive a more rigorous approach to how banks approach their responsible lending obligations. Banks are already responding by implementing more rigorous testing of borrowers' income and living expenses. The widespread adoption of comprehensive credit reporting (1 July) will also enable banks to have more thorough insight into potential borrowers spending patterns.

Commission structure for mortgage brokers is also under review and any changes will probably lean towards a more conservative flat-fee structure, which could reduce credit availability for some borrowers. The next Federal election will most likely have negative gearing on the agenda as a policy difference between the major parties. Current polling has the Labor party ahead of the Coalition. Labor currently has a policy to limit negative gearing to new developments, so if elected this would be another headwind to lending growth.

These factors make it almost impossible to argue that there will not be at least a reduction in credit growth in the short-to-medium term. A mild reduction in credit growth would be a headwind for consumers and most likely have some incremental flow-on effect to housing and consumer behaviour. The bigger risk would be if the reduction in credit availability snowballed into a fully blown credit crunch.

Even before the Royal Commission regulators had been implementing macro-prudential policy changes aimed at reducing the level of credit availability in certain market segments. Investor and interest-only loans had already been targeted. Policy makers were obviously concerned and attempting to mitigate major issues. However, we doubt that they are targeting such a material reduction in credit that it will lead to a credit crunch. In fact, several of these policies have already been eased. We see some parallels with any recommendations that might come from the Royal Commission in that it is not the regulator's intention to drive a material reduction in credit availability, but rather a more thorough application of the banks' responsible lending obligations. That said, the current political dynamics make it a challenging policy task and we are conscious that policy missteps do occur.

Portfolio positioning

Key considerations

1. Inflation. We are underweight bond proxies and have reduced our exposure to higher price-earnings (PE) ratio names.
2. Household debt to GDP is elevated. We are underweight consumer stocks and banks.
3. Corporate debt is low, and capex is rising. We have an exposure to companies invested in mining and infrastructure spending.
4. The resource cycle is turning. We are overweight major resources.
5. The interest rate differential to the US suggests Australian dollar weakness. We are overweight offshore earners.

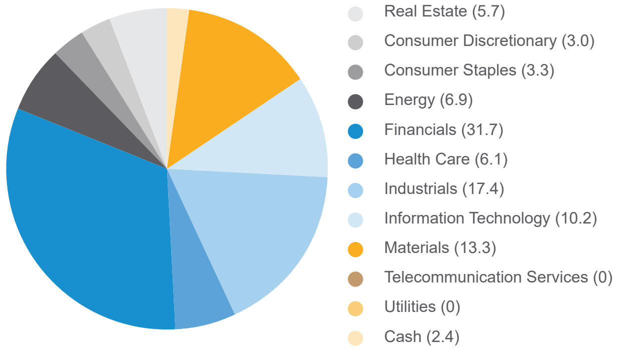
We have been building positions in a range of de-rated quality names that offer good defensive characteristics and good growth. In addition, we have found opportunities in growth companies like CYBG (ASX:CYB) and companies whose balance sheets and outlooks have improved substantially, like Woodside Petroleum (ASX:WPL).

Portfolio moves

No major changes to the portfolio during May.

Portfolio attribution

Sector weightings %



Source: DNR Capital

12 month - top contributors and detractors

Top 5 contributors		Alpha*
Telstra Corporation	No Holding	1.35%
Aconex	Overweight	1.24%
Macquarie Group	Overweight	0.72%
BWX	Overweight	0.71%
Commonwealth Bank of Australia	Underweight	0.66%
Top 5 detractors		
CSL	No Holding	-1.34%
Aurizon Holdings	Overweight	-1.03%
Link Administration Holdings	Overweight	-0.71%
MYOB Group	Overweight	-0.70%
Brambles	Overweight	-0.68%

Monthly - top contributors and detractors

Top 5 contributors		Alpha*
IPH	Overweight	0.64%
BWX	Overweight	0.64%
Telstra Corporation	No Holding	0.30%
Macquarie Group	Overweight	0.21%
Commonwealth Bank of Australia	Underweight	0.19%
Top 5 detractors		
Link Administration Holdings	Overweight	-0.58%
CSL	No Holding	-0.38%
MYOB Group	Overweight	-0.36%
Brambles	Overweight	-0.33%
National Australia Bank	Overweight	-0.19%

** 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:

- IPH (ASX:IPH)—Announced an on-market share buyback of up to $40m and also provided an update on current position and growth strategy. IPH's strategy is focused on maintaining its leading market position in Australia, New Zealand and Singapore, and expanding market share in Asian jurisdictions. Management is looking to strengthen patent capability in China to increase market share.
- BWX (ASX:BWX)—Has received a non-binding, indicative takeover bid at A$6.60/share from a group led by BWX's CEO and CFO and backed by Bain Capital.
- Telstra Corporation (ASX:TLS, no holding)—Telstra's dominance is under threat with TPG Telecom launching trial services later this year as Australia's fourth mobile network operator. Telstra may seek overseas acquisitions to mitigate falling fixed-line profit at home amid the rollout of the national broadband network (NBN), while boosting spending to improve network and service quality. Telstra will slash its dividend to 70–90% of recurring earnings, departing from the prior practice of making close to a 100% payout.

The top stock detractors were:

- Link Administration Holdings (ASX:LNK)—Shares were under pressure by changes announced in the Federal Budget requiring that funds under $6,000 with no contribution for 13 months be transferred to the ATO. This change will impact the number of accounts administered by Link's Funds Administration division and could potentially result in the loss of up to $55m in revenue. There are several potential measures available to Link, which should go some way to offset the lost revenue.
- CSL (ASX:CSL, no holding)—The stock was up 9% during May after the company upgraded its earnings guidance. We have underestimated the ability of CSL to take advantage of the current structural positioning within the industry.
- MYOB Group (ASX:MYO)—Announced that it was no longer pursuing the acquisition of the RAG business from Reckon after the Australian Competition and Consumer Commission (ACCC) expressed concerns that the transaction may lessen competition. The transaction would have been accretive to earnings and at the time of the initial announcement MYOB also announced its intention to increase investment in R&D, which largely offset the accretion. With the transaction now not proceeding, MYOB has decided to continue the investment in higher R&D and this has resulted in a margin decline in the short term.

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.

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.

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