Australian Equities High Conviction Portfolio

Performance Report – May 2018

Market overview and portfolio performance

Jamie Nicol
Chief Investment Officer

Scott Bender
Portfolio Manager

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 High Conviction Portfolio underperformed its benchmark for the period.

Portfolio overview

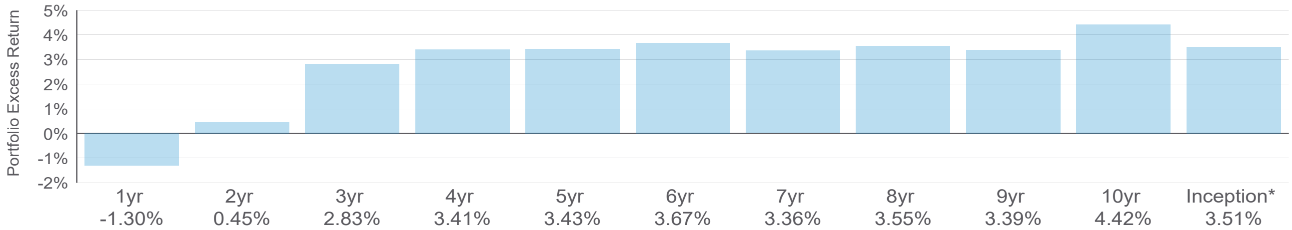
Investment bias	Style neutral
Designed for	Investors with a medium-term investment objective focused on achieving portfolio growth with less focus on generating excess income and is prepared to accept higher volatility in pursuit of higher growth
Benchmark	S&P/ASX 200 Accumulation Index
Investment objective	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

Gross active return

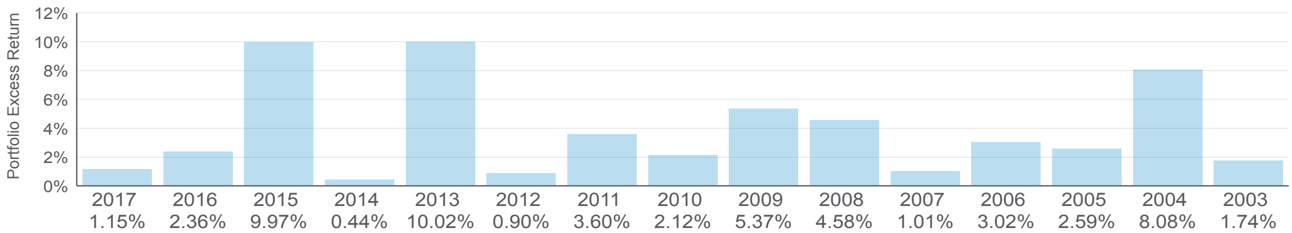
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
High Conviction Portfolio	-1.24	0.47	2.52	8.33	8.77	12.19	11.70	9.66	12.80
S&P/ASX 200 Accumulation Index	1.09	1.08	2.81	9.63	5.94	8.76	8.34	5.24	9.29
Excess Return	**-2.33**	**-0.61**	**-0.29**	**-1.30**	**2.83**	**3.43**	**3.36**	**4.42**	**3.51**

** Inception date—October 2002*

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

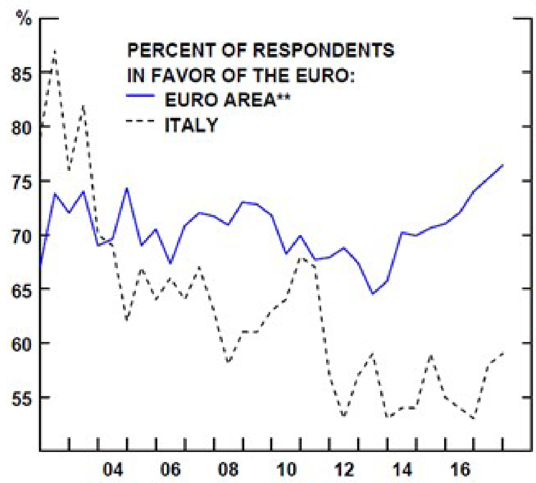
While most markets ended the month up in absolute terms, May saw geopolitical risks once again bubble to the surface. The roundabout of Italian politics looks set to continue with the interim government on shaky ground, while global trade tensions continue to rise. This month we will explore these issues 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.

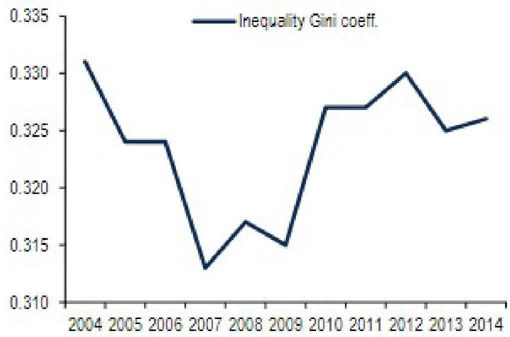
Italian voter support for euro



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.

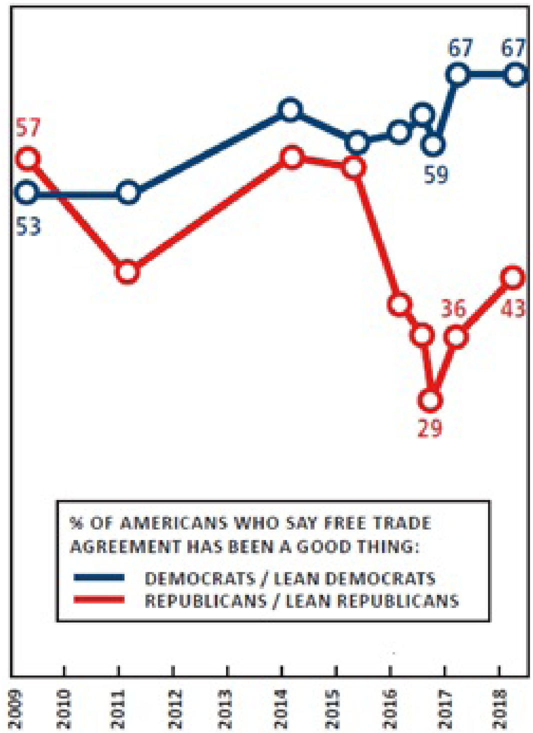
The volatile political situation is leading to more conservative positioning in financial markets. We have already seen money flowing into US treasuries with the US 10-year bond yield falling back under 3%. The sustainability of the move will depend on near-term news flow, however the longer-term outlook 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 and we note that Treasury Wine Estates (ASX:TWE) has talked to a slowing of customs processing times. 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



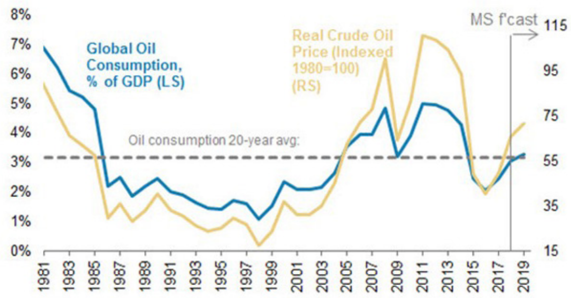
Source: Pew Research

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 globalf 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 regulators 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.

May was a difficult one for the portfolio as a number of factors impacted relative performance.

1. Macroeconomic risks were prominent with concerns around the Italian election result and the ongoing sabre rattling of trade wars. This saw a return of the 'risk off trade', which did not favour our positioning given we are underweight those stocks that benefit from lower bond yields.
2. The market continues to reward a narrow range of growth stocks that are trading on higher and higher multiples. CSL (ASX:CSL, no holding) is discussed below, but more generally we are focused on maintaining valuation discipline and are avoiding stocks where price momentum is not supported by valuation.
3. We experienced some stock-specific announcements including Link Administration Holdings (ASX:LNK), MYOB Group (ASX:MYO) and Treasury Wine Estates (ASX:TWE), which we discuss below.

The portfolio has been positioned in high-quality businesses that are supported by valuation upside. The portfolio has a superior earnings growth, cash flow and return trends compared to the market. We expect the portfolio to generate outperformance as a more inflationary environment drives a more disciplined approach to valuations.

Major detractors:

Link Administration Holdings (ASX:LNK, down 60bps) was hurt 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 that should go some way to offset the lost revenue.

Super account consolidation is not a new theme and we were always expecting further consolidation in the medium term. The policy change will accelerate this process and while it is negative for near-term earnings, it does not change the long-term fundamentals for the super administration business and, in fact, makes Link's competitive position even stronger relative to its peers.

The shares have declined more than the potential unmitigated impact of the changes and we think the multiple de-rating reflects market nervousness following the announcement of a customer loss and the timing of the recent capital raising. We do not think the underlying dynamics of any of Link's businesses have fundamentally changed and the medium-term growth profile of the business remains strong. We acknowledge that it may take some time for the market to regain confidence, however even if we assume no mitigation of lost revenue the current valuation is compelling and we have added to the position during May.

CSL (ASX:CSL, no holding, down 37bps) 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 and our underweight position has been a significant headwind to the portfolio's relative performance.

The CSL business continues to trade very strongly with several new products quickly gaining traction and competitors struggling to work through production issues. The underlying markets for CSL's products continue to grow well and CSL now has a significant advantage over its competitors given the additional plasma collection centres it has opened over the last three years. This access to raw material has meant that CSL has been able to meet market demand at a point where competitors are struggling and it has been able to leverage its position into strong pricing, and hence margin outcomes.

CSL products have relatively short life cycles and it will need continued successful product launch to maintain earnings momentum. Product evolution, and support of evolving treatment methods, are also characteristic of CSL's markets. The company is trying to leverage its size and current position into material research and development (R&D) and capex programs with the aim of extending the current strong competitive position into the medium-to-long term. We see this as a logical strategy for CSL, but not one entirely without risk.

CSL is a well-managed company with a strong market position and the shares should trade at a premium to the market. Over the last 10 years this premium has been 1.4 times the market PE ratio. Currently that premium sits at more than 2.2 times the market PE. At these levels we would need to assume that CSL not only continues to execute its own strategy perfectly, but also that its competitors continue to struggle indefinitely. Even if this was to eventuate, we struggle to see upside from current valuation levels.

MYOB Group (ASX:MYO, down 27bps) announced that it was no longer pursuing the acquisition of the RAG business from Reckon after the 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 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.

The accounting software industry is undergoing a change and there is the potential for a significant uplift in 'lifetime value of customer' under a SaaS model. MYOB has a strong presence in desk-based software solutions and the ability to successfully transition these customers to cloud-based solutions would result in a material uplift in the value of these customers to MYOB. The competition for cloud customers is intense, but MYOB has an advantage given its extensive customer base. While its current offering is competitive, it is crucial that the company invests in development in order to successfully transition customers to the cloud.

At this point in the transition from desktop to cloud-based accounting we think the decision to invest is the correct one and we have added to the position during the month.

Treasury Wine Estates (ASX:TWE, down 27bps) fell 13% in May after a series of press articles suggesting that the company was facing an overstock issue for certain lower-end brands in the Chinese market. The basis of the concerns revolved around evidence of price discounting at a retail level and was amplified by statements from several distributors that Treasury had been too aggressive in forcing distributors to take allocations of lower-end wines.

Over the last two to three years, Treasury has made significant changes to the way it distributes its products in China. Historically, local companies were the exclusive method used for distribution. However, with the increasing importance of the market, the decision was made to reorganise the distribution channel and Treasury took over the major accounts directly and the remaining distributors were more tightly monitored. This reduced the distribution margin overall and gave Treasury more visibility around the sell-through of volumes. Distributors that Treasury saw as not being strong partners were terminated. The distributors were understandably disappointed and we are not surprised that several have been making negative comments in the press.

Pricing has always been volatile in the lower-value products and is nothing new. However, we are cognisant that Treasury may have been overly aggressive in forcing distributors to take high volumes of lower-value wines in order to secure their allocations to the higher-value wines like Penfolds. This is something that Treasury will have to manage carefully. We don't think that the profit impact of reduced lower-value shipments will be material, but we are watching that the perception of the higher-value brands is not damaged in the process.

The outlook for Treasury remains strong. The business has a large inventory of wine to sell through over the next two to three years that will underpin strong growth to 2021. The underlying demand remains strong and we remain comfortable with the outlook for Treasury.

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.

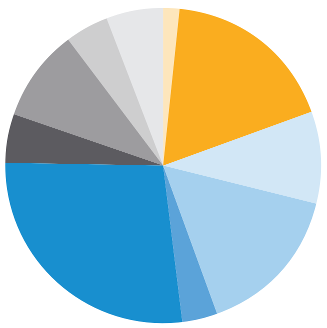
We have been building positions in a range of de-rated quality names like Woolworths Group (ASX:WOW) that offer good defensive characteristics and good growth. In addition, we have found opportunities in growth companies like CYBG (ASX:CYB) and companies whose balance sheets and outlooks have improved 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	1.32%
Macquarie Group	Overweight	0.70%
Commonwealth Bank of Australia	Underweight	0.69%
Treasury Wine Estates	Overweight	0.57%
Lendlease	Overweight	0.54%
Top 5 detractors		
CSL Limited	No Holding	-1.31%
Aurizon Holdings	Overweight	-1.01%
Tabcorp Holdings	Overweight	-0.79%
Link Administration Holdings	Overweight	-0.69%
Brambles	Overweight	-0.56%

Monthly - top contributors and detractors

Top 5 contributors		Alpha*
Telstra Corporation	No Holding	0.29%
Commonwealth Bank of Australia	Underweight	0.21%
Lendlease	Overweight	0.19%
Macquarie Group	Overweight	0.19%
REA Group	Overweight	0.08%
Top 5 detractors		
Link Administration Holdings	Overweight	-0.60%
CSL	No Holding	-0.37%
Brambles	Overweight	-0.32%
James Hardie Industries	Overweight	-0.31%
MYOB Group	Overweight	-0.27%

** 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:

- 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.
- Commonwealth Bank of Australia (ASX:CBA)—Reported a particularly weak 3Q18 trading update, with cash net profit after tax (NPAT) and pre-provision profit both down 9% on the quarterly average of 1H18. This was mainly due to non-interest income being down ~8% and underlying operating expenses being up 3%.
- Lendlease (ASX:LLC)—Shares outperformed as the market focused on several of its key European and UK projects, which should deliver attractive returns on capital efficient terms. While some projects are longer-dated, the European business is expected to be a meaningful contributor to earnings over the medium-to-long term.

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 that 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 and our underweight position has been a significant headwind to the portfolio's relative performance.
- Brambles (ASX:BXB)—Continues to generate solid revenue growth, however movements in input costs are putting pressure on the margin. Lumber and freight costs have both risen strongly over the last 12 months and while Brambles has the capacity to pass on higher input costs via tariffs and surcharges, these are unlikely to cover the full increase 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 High Conviction Portfolio has an investment style best described as 'style neutral'. 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 environmental, social and governance (ESG) risk.

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.

Platform access

- AMP PPS
- BT Direct
- BT Panorama
- Colonial First State FirstWrap
- Federation Alliance
- HUB24
- Linear
- Macquarie Wrap
- Mason Stevens
- Netwealth
- OneVue
- Powerwrap
- Praemium

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