Australian Equities High Conviction 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 High Conviction Portfolio underperformed its benchmark by 0.75%.

Portfolio overview

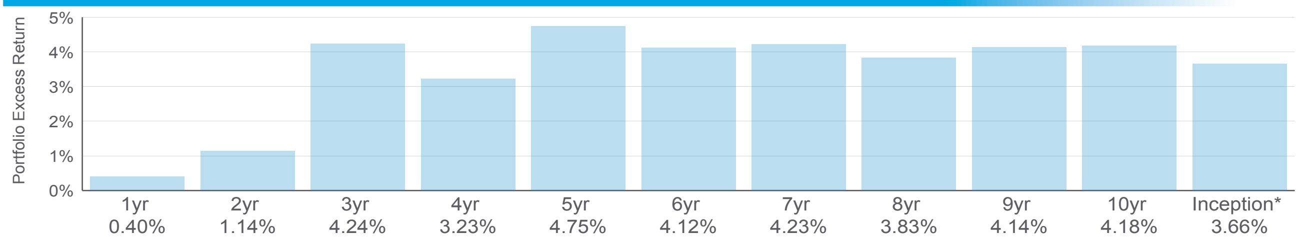
Investment bias	Style neutral
Designed for	Investors with a medium-term investment objective focused on achieving portfolio growth with less focus on generating excess income and is prepared to accept higher volatility in pursuit of higher growth
Benchmark	S&P/ASX 200 Accumulation Index
Investment objective	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
Investment timeframe	5 years
Portfolio managers	Jamie Nicol (Chief Investment Officer) Scott Bender (Portfolio Manager)

Gross active return

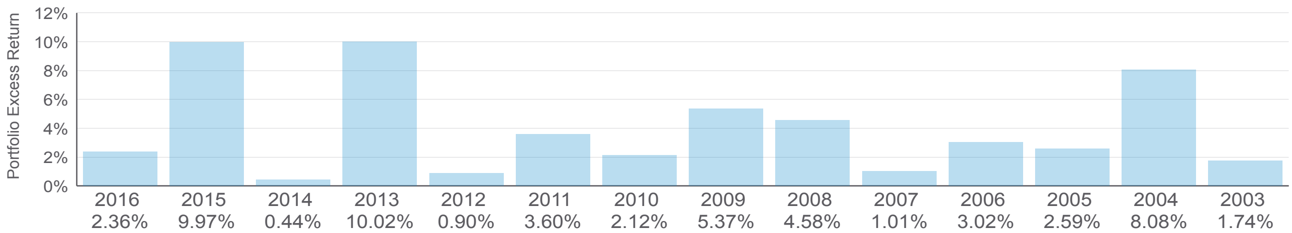
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
High Conviction Portfolio	0.89	5.92	5.67	15.01	12.96	15.31	12.84	7.84	13.07
S&P/ASX 200 Accumulation Index	1.64	5.71	6.63	14.61	8.72	10.56	8.61	3.66	9.41
Excess Return	**-0.75**	**0.21**	**-0.96**	**0.40**	**4.24**	**4.75**	**4.23**	**4.18**	**3.66**

** Inception date—October 2002*

Annualised excess return



Excess return (calendar year)

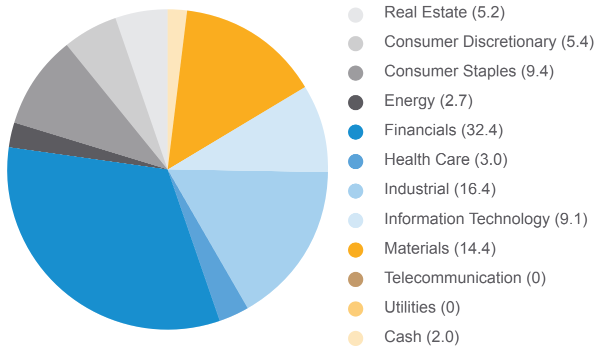


Source: DNR Capital

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.

Sector weightings %



Source: DNR Capital

12 month - top contributors and detractors

Top 5 contributors		Alpha*
Telstra Corporation	No Holding	1.61%
Treasury Wine Estates	Overweight	0.99%
Janus Henderson Group	Overweight	0.60%
REA Group	Overweight	0.59%
ANZ Banking Group	No Holding	0.44%
Top 5 detractors		
CSL	No Holding	-0.99%
Healthscope	Overweight	-0.88%
Brambles	Overweight	-0.77%
SKYCITY Entertainment Group	Overweight	-0.36%
Cash	Overweight	-0.34%

Monthly - top contributors and detractors

Top 5 contributors		Alpha*
Janus Henderson Group	Overweight	0.24%
ANZ Banking Group	No Holding	0.21%
James Hardie Industries	Overweight	0.20%
Brambles	Overweight	0.19%
REA Group	Overweight	0.18%
Top 5 detractors		
ALS	Overweight	-0.35%
National Australia Bank	Overweight	-0.29%
IRESS	Overweight	-0.20%
MYOB Group	Overweight	-0.19%
Lendlease	Overweight	-0.16%

** 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.
- 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.
- James Hardie Industries (ASX:JHX)—Reported a 1H result for the six months ended 30 September, which was well received with shares rising 7.6% on the day of the announcement.

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.
- IRESS (ASX:IRE)—The company provided guidance for FY17 that disappointed the market. Based on the update and a subsequent conference call, it appears that higher cost investment during FY17 has led to less revenue growth than expected (in part attributed to delays around client decisions).

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), Qube Holdings (ASX:QUB) 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) and James Hardie Industries (ASX:JHX).

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 Woolworths (ASX:WOW), 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

Purchase of Woodside Petroleum (ASX:WPL)

WPL is an Australian oil and gas company involved in hydrocarbon exploration, evaluation, development, production and marketing. WPL's key assets are the North-West Shelf and Pluto Liquid Natural Gas (LNG) projects. It also has a portfolio of offshore platforms, oil floating production storage and off-loading vessels.

WPL meets DNR Capital's five-point quality web:

1. Industry structure—The oil and gas industry has faced a number of difficult years but is improving as supply and demand dynamics are balancing out. The LNG industry outlook is also improving as China transitions from coal-fired power generation to gas. Key offtakers for WPL's LNG are based in Asia where there is little indigenous gas and these customers value security of supply.
2. Earnings strength—Earnings are underpinned by a high-quality asset base with operating costs equivalent to US$4.90/barrel of energy (boe). Cash flow is strong to support debt repayments, capex and dividends. The business is free cash flow positive at US$34/boe.
3. Balance sheet—Gearing is at 24%, within management's guidance of 10–30%. Gearing remains well below peers.
4. Management—Peter Coleman was appointed managing director in 2011. Peter has 30 years' experience in the oil and gas industry, 27 of those with ExxonMobil. Peter has brought a disciplined approach to WPL with good capital allocation decisions.
5. Environmental, social and governance (ESG)—WPL is involved in conventional oil and gas drilling, which carries less environmental risk than unconventional gas like coal seam gas LNG (which requires thousands of gas wells to be drilled).

Key risks

- Oil prices stay lower for an extended period of time.
- Pluto LNG re-pricing risk in 2019, although strong demand from China for LNG will provide an offset.
- Key discoveries remain undeveloped. Browse and Sunrise resources were discovered many years ago and different joint venture partners may struggle to agree on a unified development concept.

Valuation

We value WPL using the oil-forward curve, which implies shares are trading close the current valuation. But we see upside as growth projects are de-risked.

Conclusion

We have used the recent weakness in the WPL share price following Shell's exit from the register to establish a position. WPL has a world-class portfolio of assets with a strong production profile and free cashflow. WPL is led by a strong management team that has demonstrated strong capital discipline. Browse and Sunrise are the key growth opportunities, but the company has also acquired a number of attractive growth options (Senegal, Kitimat, Myanmar) in recent years that should be de-risked over time.

Sale of Oil Search (ASX:OSH)

We have exited our position in OSH as we are concerned about the company's change of strategy with the recent foray into Alaska. From the company's point of view, diversifying into Alaska makes strategic sense as it reduces single-source geographic and sovereign risk. However, from an investment point of view it makes the OSH story more difficult to digest:

1. It has no expertise in Alaskan oil.
2. It has no expertise operating such an asset. Exxon Mobil operates its Papua New Guinea (PNG) assets.
3. Change in strategy from a pure play PNG exposure.
4. Funding will be a concern as it will potentially be developing PNG and Alaska at the same time. As a consequence, both balance sheet and management expertise will potentially be stretched.
5. OSH is entering a larger capex phase with production declining from PNG LNG for the next six years until both projects (PNG expansion, Alaska) come on board in 2023.

We have deployed these funds into WPL, which offers a better risk-adjusted return.

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
- Federation Alliance
- HUB24
- Linear
- Macquarie Wrap
- Mason Stevens
- Netwealth
- OneVue
- Powerwrap
- Praemium

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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