Australian Equities High Conviction Portfolio

Performance Report – February 2018

Market overview and portfolio performance

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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 High Conviction Portfolio slightly outperformed its benchmark for the period by 0.09%. Key stock contributors were Lendlease (ASX:LLC), Telstra Corporation (ASX:TLS, no holding) and James Hardie Industries (ASX:JHX). Key stock detractors were CSL (ASX:CSL, no holding), Janus Henderson Group (ASX:JHG) and Tabcorp Holdings (ASX:TAH).

Portfolio overview

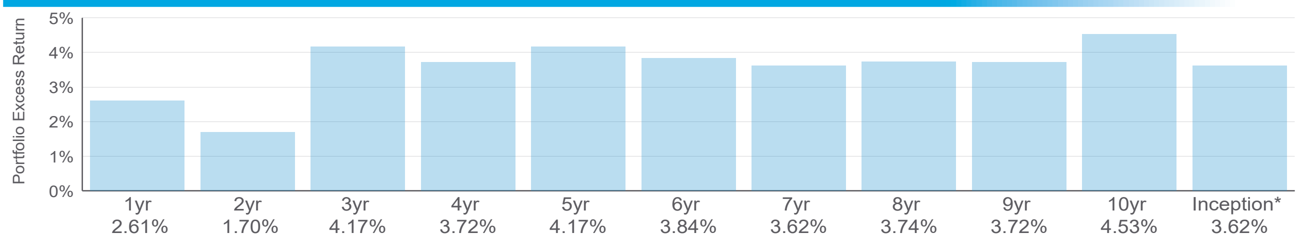
Investment bias	Style neutral
Designed for	Investors with a medium-term investment objective focused on achieving portfolio growth with less focus on generating excess income and is prepared to accept higher volatility in pursuit of higher growth
Benchmark	S&P/ASX 200 Accumulation Index
Investment objective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

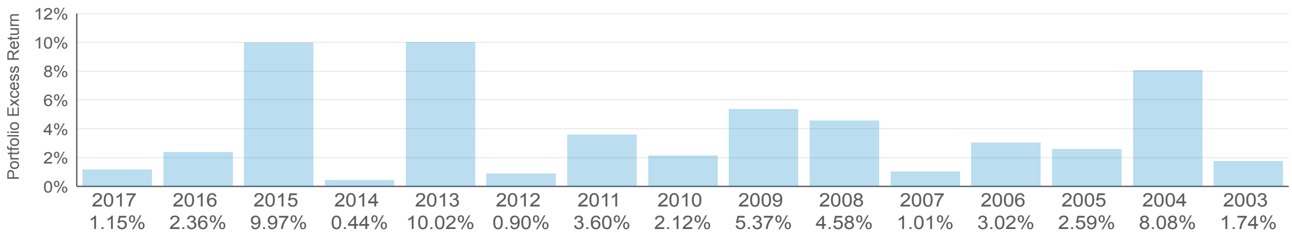
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
High Conviction Portfolio	0.45	2.04	8.08	12.71	9.24	12.18	11.55	9.93	12.99
S&P/ASX 200 Accumulation Index	0.36	1.72	7.52	10.10	5.07	8.01	7.93	5.40	9.37
Excess Return	**0.09**	**0.32**	**0.56**	**2.61**	**4.17**	**4.17**	**3.62**	**4.53**	**3.62**

** 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.

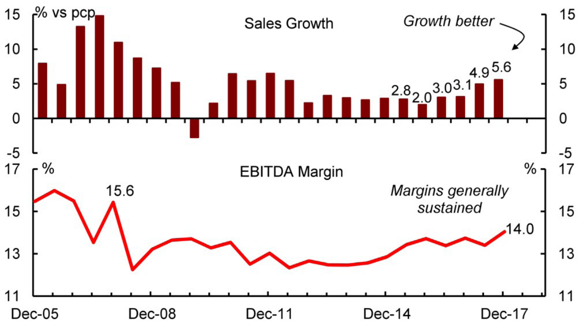
Portfolio review

The portfolio performed solidly during reporting season with a pleasing set of results, especially by the larger positions in the portfolio. The portfolio missed most of the poorer results in the market, but also missed some of the better results. The result was slight outperformance. 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, providing further tailwind.

Growth from Australian Companies



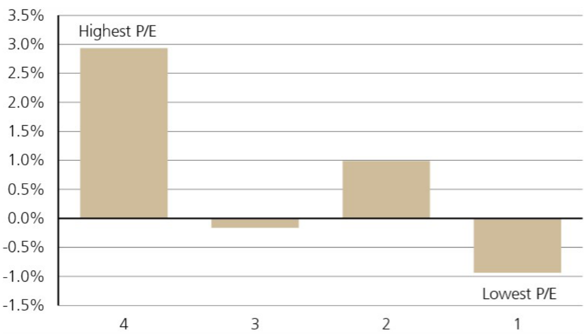
*Source: Company data, Citi Research *Also excludes Telstra Corporation (ASX:TLS)*

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 so 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.

James Hardie Industries (ASX:JHX)
James Hardie's 3Q result was a positive surprise with earnings before interest and taxes (EBIT) up 33% on the prior comparative period. Profit margins in the US beat expectations as the company bedded down recent operating issues. Revenue growth was 7%, which was largely in line with expectations and in line with the market. Following operational issues in the past 18 months, the business appears to be back on track and we would expect it to focus on winning back share over the next year. The market lifted forecasts by 2% on the back of this result. We added to the position following the result.

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 because 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 and 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.

IRESS (ASX:IRE)
IRESS had a disappointing year with revenue up 10% but profit up only 1%. There was a step up in costs during the year for a number of reasons including a need to set up new clients (which will fall away), and greater spending on staff to attract and retain good staff in the competitive IT space. This will also impact the outlook for FY19 with growth of 3–7% expected. The stock has understandably sold off as a result. The market position of the company remains strong, the valuation reasonable and the cash flow and returns are attractive. We are yet to add to the small position in the portfolio as we seek greater clarity on the performance of the UK operation.

Tabcorp Holdings (ASX:TAH)
Tabcorp had a soft half with EBITDA 6% below expectations with a poor win rate during November and December impacting wagering earnings. It has lost some share to online bookmakers during the period. The market downgraded earnings by circa 5% on an ongoing basis. We note that this was a backward-looking result. The future will be dictated by the Tatts integration and a change in laws, which is making it more difficult for online bookmakers (point of consumption tax, advertising restrictions, ban on credit betting). Furthermore, we are attracted to the defensive characteristics of the lotto earnings and as a consequence added to the stock into the weakness.

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.

Portfolio positioning

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

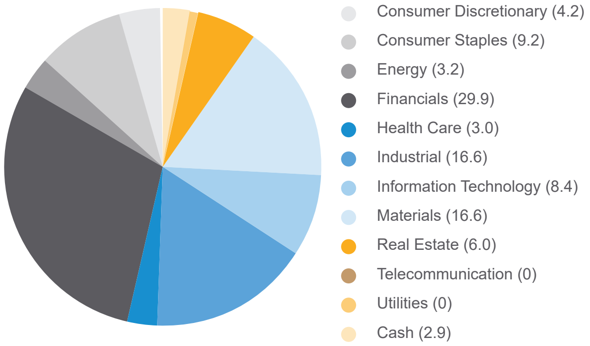
- Being significantly underweight bond proxies.
- Reducing our exposure to high PE quality stocks with many of our positions substantially reduced.
- Reducing our exposure to market-exposed stocks.
- Increasing our exposure to those stocks with improving quality characteristics. Many of these companies are exposed to the improving global growth outlook including ALS (ASX:ALQ) as mining exploration activity recovers, WorleyParsons (ASX:WOR) as oil and gas capex spend increases and James Hardie Industries (ASX:JHX) as US consumer confidence drives housing activity and as its margins recover. Valuations for these types of companies will be supported by rising earnings and they have a low correlation to bond yields.
- Increasing our exposure to de-rated quality companies like Woolworths Group (ASX:WOW), Lendlease (ASX:LLC), Brambles (ASX:BXB) and Tabcorp Holdings (ASX:TAH). These companies have suffered over the past year or so but their outlooks remain robust (Woolworths Group is back winning market share, Lendlease, despite a hiccup, is exposed to infrastructure spend, Brambles is winning business after a stumble and Tabcorp Holdings has legislation changes and an integration to support it). 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.
- Maintaining quality stocks that tend to have lower debt levels relative to the market and therefore earnings are not 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*
Telstra Corporation	No Holding	1.18%
Treasury Wine Estates	Overweight	0.98%
Lendlease	Overweight	0.74%
Janus Henderson Group	Overweight	0.68%
SEEK	Overweight	0.61%
Top 5 detractors		
CSL	No Holding	-1.04%
Healthscope	Overweight	-0.86%
Aurizon Holdings	Overweight	-0.57%
Tabcorp Holdings	Overweight	-0.55%
The a2 Milk Company	No Holding	-0.44%

Monthly - top contributors and detractors

Top 5 contributors		Alpha*
Lendlease	Overweight	0.69%
Telstra Corporation	No Holding	0.17%
James Hardie Industries	Overweight	0.13%
Wesfarmers	No Holding	0.11%
National Australia Bank	Overweight	0.11%
Top 5 detractors		
CSL	No Holding	-0.47%
Janus Henderson Group	Overweight	-0.31%
Tabcorp Holdings	Overweight	-0.28%
IRESS	Overweight	-0.23%
The a2 Milk Company	No Holding	-0.17%

** 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.
- James Hardie Industries (ASX:JHX)—Reported 3Q18 results that were above expectations with adjusted net profit after tax (NPAT) of US$69.9m, driven by a very strong North American margin outcome. This result confirmed that JHX's operational performance is back near targeted levels, where the strong cyclical impulse from a solid US housing market can more fully come to the fore.

The top stock detractors were:

- CSL (ASX:CSL, no holding)—Underlying 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.
- Janus Henderson Group (ASX:JHG)—Reported a strong 4Q17 result but flows of -$2.9b were below expectations, deteriorating from +$0.7b last quarter. Alternative outflows of $0.6b, driven by a portfolio manager change in an absolute return bond strategy and Intech outflows of $1.6b, were the primary drivers of the weak flows during the quarter. The integration of the Janus Henderson Group is ahead of expectations.
- Tabcorp Holdings (ASX:TAH)—Despite a strong start to the half (+4.5% in 1Q18), wagering and media appear to have declined in 2Q led by weakness in tote (-7.5%), trackside (-14.0%) and media (-1.1%), where growth was much lower than in 1Q due to increased competitor activity before the credit betting ban kicks in.

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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