Australian Equities Income Portfolio

Performance Report – September 2018

Market overview and portfolio performance

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The S&P/ASX 200 Industrials Accumulation Index (the portfolio's benchmark) fell 2.81%, during September. Rising global bond yields resulted in weakness across the Health Care, Consumer Discretionary and Utilities sectors. Telecommunications was the best performing sector. Meanwhile, the banks continued to struggle beneath the weight of their own Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission), with the Interim Report handed down at month end.

The DNR Capital Australian Equities Income Portfolio performed well, outperforming its benchmark during the month.

The portfolio's dividend yield expectation for calendar year 2018 is currently 5.40% (7.10% grossed up for franking credits).

Portfolio overview

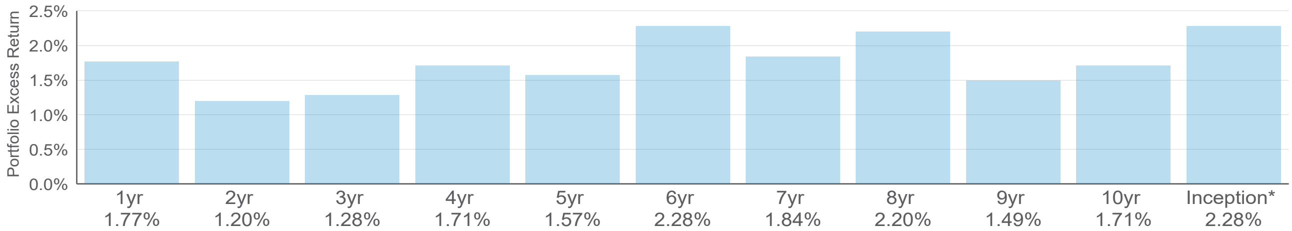
Investment bias	Style neutral
Designed for	Investors who seek a greater level of income and who can make use of franking credits
Benchmark	S&P/ASX 200 Industrials Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Industrials Accumulation Index and deliver higher levels of income (before fees) over a rolling three year period
Investable universe	ASX listed securities with a focus on S&P/ASX 200
Number of stocks	15–30
Asset allocation	Australian equities 80–100% Cash 0–20%
Portfolio stock limit	15% maximum weighting
Minimum suggested investment timeframe	5 years

Gross active return

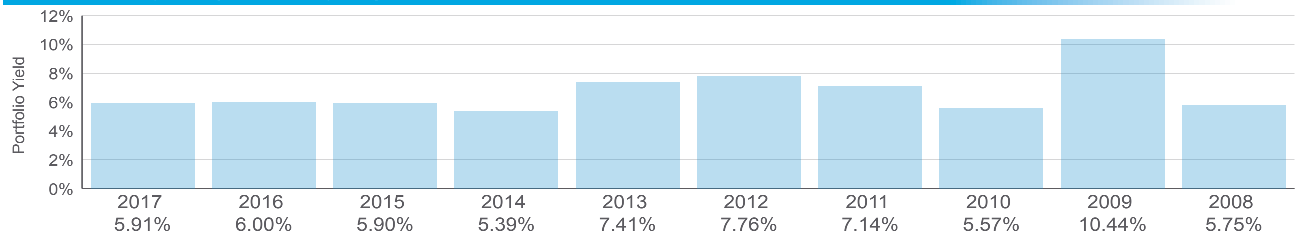
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Income Portfolio	-0.99	3.81	11.32	12.40	11.36	10.43	15.75	11.15	7.74
S&P/ASX 200 Industrials Accumulation Index	-2.81	1.71	8.48	10.63	10.08	8.86	13.91	9.44	5.46
Excess Return	**1.82**	**2.10**	**2.84**	**1.77**	**1.28**	**1.57**	**1.84**	**1.71**	**2.28**

** Inception date—December 2007*

Annualised excess return



Grossed-up yield (calendar year)*



**Grossed-up yield includes franking credits*
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

Are markets late cycle?

In our view, it is likely that markets are late cycle. There are some amber lights, which suggests caution is warranted:

- US Markets—Longest bull run in recorded history.
- S&P/ASX 200 Industrials Accumulation Index recently reached all-time highs at ~22x price-earnings ratio (PE).
- Aggressive valuation methodologies are being introduced (e.g. enterprise value (EV)/Sales).
- The US yield curve has been flattening.
- Companies are implementing more capital management initiatives indicating a lack of alternatives.

US recessions and yield curve

Source: BOFA Merrill Lynch Global Investment Strategy, Bloomberg, Global Financial Data

However, positive signals are persisting:

- Robust economic activity across key regions (US, Europe, China).
- Economic activity is also accelerating in some areas like mining spending and infrastructure.
- Fiscal stimulus/populist policies ongoing.
- Markets have not reached the euphoric stage typically associated with the end of the cycle.

World Industrial Production Growth

Source: Macquarie Research

Whilst there may still be some way to go–we are cautious about a number of 'black swan' events that could have negative impacts on markets:

- President Trump/China trade wars.
- US mid-term elections.
- Brexit.
- Uncertain political climate generally.
- Rising inflation and interest rates.

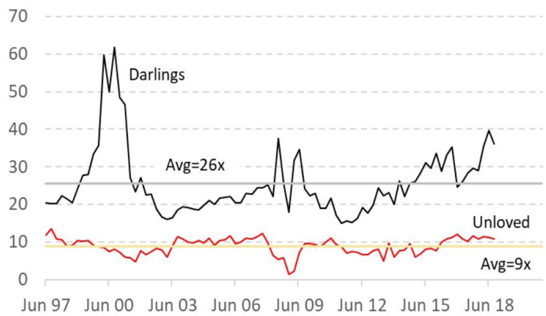
Loved versus unloved stocks

Recently, a narrow range of companies and sectors have been experiencing very strong returns.

- In particular, Information Technology, Health Care and those exposed to China.
- Digital disruption has been improving emerging companies growth versus traditional industries.
- Traditional companies with structural issues include Telstra Corporation, banks and hospitals.

As such, the gap between market-loved stocks and unloved stocks is high by historical standards.

12-month forward absolute PE for Aussie market darlings and unloved (median for basket, calculated quarterly)

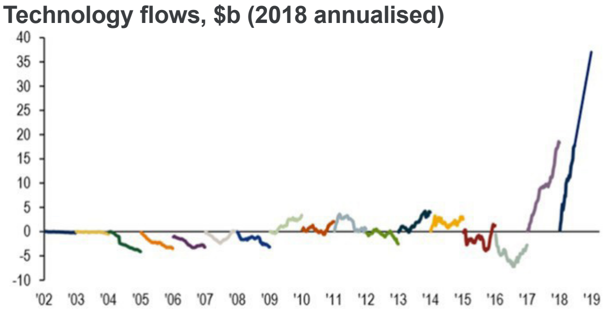


Source: Company Data, Datastream, MST Marquee

Low interest rates and quantitative easing (QE) means the world has been awash with liquidity.

- This liquidity has been chasing parts of the market with growth prospects.
- Technology space has been a big beneficiary.
- Quantitavie strategies support these sectors with good momentum and low historical volatility creating a positive feedback loop.

Technology flows, $b (2018 annualised)



Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global

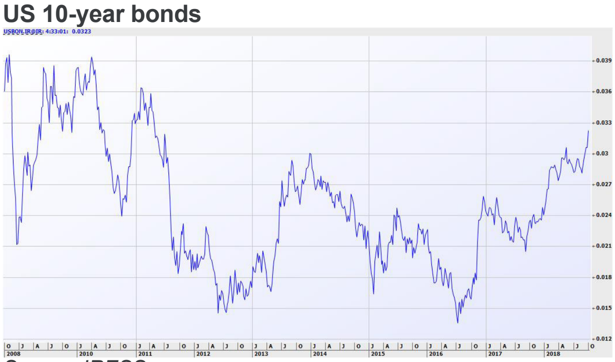
We are concerned these trades are becoming crowded, and some caution is warranted.

- Aggressive valuation assumptions using low risk-free rates.
- New valuation techniques such as price-to-sales.
- Heavy use of vague addressable market assumptions to increase the terminal value.

Factors that could cause the market to reassess valuations include:

- The potential for inflation. Higher interest rates will result in a rotation in markets and also impact the terminal value in valuations.
- As growth stock multiples extend, confidence increases along with earnings expectations. Those that disappoint will be treated harshly.

US 10-year bonds



Source: IRESS

We have been reducing our exposure (active positions and overall allocations) to growth/loved stocks.

- We believe it is time for some caution.
- Market optimism means many businesses have been re-rated higher and some of these will not deserve the market darling status that they currently enjoy.
- Higher bond yields can place pressure on these extended valuations, given a significant level of value is in the terminal year.
- Some growth stocks continue to justify their valuations given their earnings growth.
- Opportunities emerging with companies that have addressed their competitive position, rebased earnings and are at lower valuations.
- In time of rapid technology change, value traps are prevalent.
- The critical consideration is to retain valuation discipline.

Royal Commision

While the Interim Report did not make preliminary recommendations, it asked 693 questions looking at the suitability of current laws, regulations and practices. The probability of changes to legislation may be lower than we thought, given the report highlights *"the premise that no new layer of law or regulation should be added unless there is a clearly identified advantage to be gained*". However, the probability of structural change now seems higher as Commissioner Kenneth Hayne noted that *"structural regulation of banking activities is not novel"* and asked whether "*the events that have happened invite consideration of whether structural changes should now be made".* We see the likelihood that regulatory oversight powers will be strengthened.

Valuations for the banks look attractive with fully franked yields of 7%, however risks and headwinds remain:

- The Royal Commission Interim Report leaves ongoing uncertainty for the sector.
- We remain concerned about remediation and the risks of financial penalties and litigation (in particular it is difficult to assess the quantum of potential loss from irresponsible lending).
- The banks are sure to be a political football heading into an election. Labor is determined to keep the banks front and centre. We see potential for a rise in the bank levy.
- Credit growth is slowing. Banks will increasingly require full verification of spending before issuing a loan. The majors are losing market share. The competitive environment remains intense.
- Ongoing headwinds from Australia's property market.
- As global bond yields increase, so does the cost of funding for the banks.
- Compliance costs will increase as banks seek to ensure these mistakes are not repeated.
- Whilst bad debts remain at record lows, these can only be headwinds going forward.

Conclusions

- Earnings are likely to be flat to down over the next three years as the impact of the Royal Commission unfolds.
- Post the inquiry the banks will have clean air. Long term there is still a cost out opportunity.
- We remain underweight banks with our financials exposure assisted by positions in Macquarie Group (ASX:MQG) and CYBG (ASX:CYB).

Portfolio positioning

A break out in rates, offsetting trade tensions and stimulus, second derivative risks from a housing correction and broadening regulatory scrutiny are all making late-cycle positioning difficult.

The portfolio's current positioning is as follows:

- Underweight bond proxies (property trusts, utilities, infrastructure and telecommunications) where we want to protect against a potential increase in inflation and unsustainably low interest rates.
- Underweight banks given risks of an overheated property market, leveraged consumer, cyclically low bad debts and the Royal Commission.
- Underweight consumer stocks due to economic softness domestically and the over-leveraged consumer.
- Overweight companies expected to benefit from global reflation and fiscal stimulus—Macquarie Group (ASX:MQG).

- Overweight companies that benefit from infrastructure stimulus and resource investment—Lendlease (ASX:LLC).
- Overweight offshore names with >50% of the portfolio earning offshore income to some degree—Brambles (ASX:BXB).

The portfolio's 12-month forward grossed-up dividend yield is 6.4%. A large number of dividends went ex-dividend in September, representing approximately ~6% of the forecast dividend yield for 2018. A further ~2% is expected to go ex-dividend during October.

Key risks

Key risks include:

1. Given valuations have been supported by low interest rates, the emergence of inflation and higher bond yields could be a negative for markets.
2. Implications of slowing growth in China, high property prices and high levels of household debt.
3. Further geopolitical uncertainty could create negative implications for stocks and portfolios.
4. The Australian housing market contains risk, with an unattractive mix of high house prices and high levels of consumer debt.

Portfolio characteristics

At DNR Capital, we categorise income generating companies as:

Growers: High-conviction stocks that may be paying a below-market dividend yield, however we see a clear path towards delivering a sustainable and growing income profile in the medium term—CYBG (CYB:ALX), James Hardie Industries (ASX:JHX).

Compounders: Quality stocks operating within a robust industry structure that have a strong competitive position, underpinning attractive and sustainable income growth—IPH (ASX:IPH), Macquarie Group (ASX:MQG).

Cows: Stocks with a solid balance sheet and capital management potential that are being undervalued on traditional earnings-based metrics—Caltex Australia (ASX:CTX), Lendlease (ASX:LLC).

Yielders: Quality companies at attractive valuations that are delivering sustainable and cash-backed dividends, however with little growth—National Australia Bank (ASX:NAB), Telstra Corporation (ASX:TLS).

Portfolio moves

Purchase of Insurance Australia Group (ASX:IAG)

IAG is the largest general insurer in Australia. Margins are at an inflexion with pricing tailwinds driving top-line growth and margins.

Investment thesis

IAG offers:

- top-line growth (2–4%)
- margin expansion (commercial pricing, moderating motor inflation, A$250m forecast savings by FY20)
- further capital initiatives
- relatively defensive earnings traits and greater earnings certainty
- potential excess reserve releases.

In addition, IAG has proposed a capital management initiative to return 25 cents per share (cps) to investors in November. This is expected to comprise of a 19.5cps capital return and a 5.5cps special dividend (100% franking). It is expected to be accompanied by an equal and proportionate consolidation of shares. This proposal is subject to shareholder vote at the AGM on 26 October.

Key risks

Insurance can suffer major catastrophes although we note IAG has significant levels of reinsurance in place and a quota share arrangement with Berkshire Hathaway.

Quality assessment

IAG meets DNR Capital's six-point quality web:

1. Industry structure—Suncorp Group (ASX:SUN) and IAG dominate the domestic retail insurance sector with >70% market share. This is one of the strongest structures globally. In addition IAG has the leading position in commercial insurance with more than 25% share. While online players have taken share in recent years they have struggled to process claims and have attracted numerous complaints.
2. Earnings strength—Returns are improving as prices rise. Furthermore a deal with Berkshire Hathaway has reduced earnings volatility and enhanced profit margins.
3. Balance sheet—Capital levels remain strong which is evidenced by the proposed capital management initiative.
4. Dividend sustainability and growth—Dividends (current yield is ~5% plus 100% franking) are supported by underlying earnings and an improving balance sheet.
5. Management—Management is the strongest in the sector with significant depth including the highly regarded Mark Milliner who was a former senior Suncorp Group executive.
6. Environmental, social and governance (ESG)—IAG has a modest risk across ESG areas.

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Valuation

Our price target (PT) is $8.00, which assumes 3–4% top-line growth medium term with improving underlying margins. The adjusted PE of the stock is a little high at ~16.5x but we believe the market is underestimating the sustainability of the growth in the current cycle.

Conclusion

Recent weakness has provided an opportunity to re-enter the stock to collect an attractive dividend of 5.5 cents plus a capital return of 19.5 cents payable in November subject to shareholder approval. Management FY19 outlook commentary appears conservative relative to current market conditions. The insurance cycle continues to accelerate which will support strong growth in dividends/further capital management.

We have reduced our banks exposure to fund the purchase of IAG.

Purchase of James Hardie Industries (ASX:JHX)

JHX participates in the residential building products industry. The company's flagship product is fibre cement, with applications in external siding, internal walls, ceilings, floors and fences.

Investment thesis

- AsiaPac. Growing market share by expanding product range e.g. decking. Market growth is flat, but it is taking share and price.
- US. Over half of the company's exposure is the repair and remodel sector and we believe the new housing market will continue to grind higher. JHX will continue to win share given further product innovation and aggressive sales. Growing sales at circa 12% p.a.—based on 4% US market growth, circa 5% market share expansion, 3% price.
- Europe. Bought into the European market in fibre gypsum which has an interesting opportunity due to changing regulation. Will also seek to expand fibre cement in that market. Double-digit growth opportunity.
- Leveraged to the US dollar and lower taxes.
- Stock is trading at a mid-teen multiple with mid-teen growth.

Key risks

A slowing housing market in the US is the key risk for JHX. However, the current recovery in the housing cycle has been one of the slowest in history. Nearly nine years in, the US is still below the average midcycle level of ~1.5m starts. While interestingly, we are a year away from the longest US economic expansion in history.

Recent housing data points have softened as the market becomes wary of rising interest rates and affordability concerns. However, it appears the softness is supply-side driven as US immigration policies are putting pressure on builder ability to source labour and deliver homes.

Demand remains strong, driven by millennial demographics and rising wages. The millennial generation provides significant demographic tailwinds to housing demand as they reach homebuying age.

Putting this together we expect a longer, elongated cycle in new housing as strong demand pushes up against limited supply.

Quality assessment

JHX meets DNR Capital's six-point quality web:

1. Industry structure—JHX pioneered, and is the world leader in, fibre cement technologies. The company's main segment is the US where it holds ~90% of the fibre cement market. Since it entered the market approximately 20 years ago, it has grown fibre cement's share of the US siding market from zero to ~20%.
2. Earnings strength—While growing share, JHX has been able to maintain strong pricing and subsequently earnings before interest and tax (EBIT) margins of 20–25%, which is world leading in building products. The company is also leveraged to a recovering US housing market.
3. Balance sheet—Despite its strong growth profile, the company has a robust balance sheet with net debt to earnings before interest, tax, depreciation and amortisation (ND/EBITDA) of ~2.4x. Its interest coverage ratio is ~7.5x.
4. Income sustainability/growth—The current 12-month forecast dividend yield is ~3% p.a. (with no franking), however we expect growth of >15% p.a. over the next three years.
5. Management—The company has had a well respected and longstanding CEO (Louis Gries), who has overseen a large majority of the company's success, however his tenure is coming to an end (by March 2019). His replacement comes from within the organisation (Dr Jack Truong, President of International Operations since April 2017) and there will be a 6-month handover, minimising the disruption. In addition, Mr Gries will remain as a consultant for two years. We are also monitoring other management changes, given a period of significant turnover over the last 18–24 months.
6. Environmental, Social and Governance (ESG)—On our metrics the company is weakest on ESG. This is due to asbestos related products previously manufactured by the company. However, we are comfortable with the fund the company established in association with the government to compensate affected individuals.

Valuation

We use a discounted cash flow to value the company and see fair value at ~$24 based on a modest recovery in housing starts.

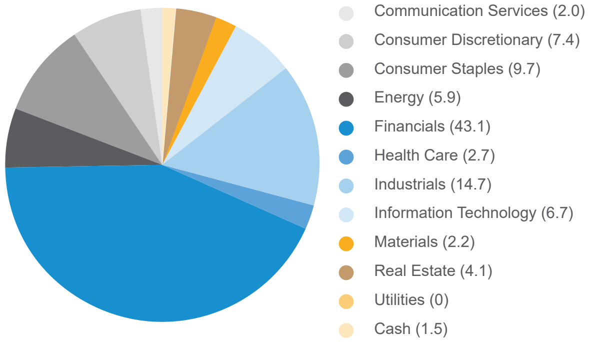
Conclusion

JHX is a quality company that provides exposure to long-term structural growth as fibre cement continues to take share in the US siding market. Additionally, the company appears set to benefit from a cyclical recovery in the US, as economic indicators point towards a stronger housing environment. We classify James Hardie Industries as a 'Grower', with dividend yield currently below market, however growth expectations of >15% p.a. over the next three years.

We have used recent stock weakness as an opportunity to purchase the stock.

Portfolio attribution

Sector weightings %



Source: DNR Capital

12 month - top contributors and detractors

Top 5 contributors		Alpha*
IPH	Overweight	0.94%
Macquarie Group	Overweight	0.75%
Commonwealth Bank of Australia	Underweight	0.66%
Brambles	Overweight	0.60%
Healthscope	Overweight	0.59%
Top 5 detractors		
CSL	No Holding	-1.99%
IOOF Holdings	Overweight	-1.01%
Aurizon Holdings	Overweight	-0.82%
Tabcorp Holdings	Overweight	-0.67%
National Australia Bank	Overweight	-0.65%

Monthly - top contributors and detractors

Top 5 contributors		Alpha*
CSL	No Holding	0.63%
IPH	Overweight	0.28%
Tabcorp Holdings	Overweight	0.19%
Woodside Petroleum	Overweight	0.17%
Brambles	Overweight	0.16%
Top 5 detractors		
Suncorp Group	Overweight	-0.14%
SEEK	Overweight	-0.06%
Westpac Banking Corporation	No Holding	-0.05%
Computershare	No Holding	-0.05%
Telstra Corporation	Underweight	-0.05%

** 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:

- CSL (ASX:CSL, no holding) —Shares retreated during the month and no holding in the shares added to the portfolio's relative performance. We have concerns around valuation and believe the market is ignoring risks around product launches, competition and cyclicality of the immunoglobulin market.
- IPH (ASX:IPH)—Shares continued to benefit from a solid FY18 result that was ahead of consensus expectations and restored investor confidence in the outlook for the group. IPH reported FY18 revenue of A$226m, which was 21.5% year on year (yoy). It was a strong operational result with EBITDA coming in at A$74.0m, up 3% yoy, and net profit after tax amortisation (NPATA) of A$51.9m. The company grew patent filings ahead of the Australian and Singapore markets and saw substantial growth in filings in China, up 44% on FY17.
- Tabcorp Holdings (ASX:TAH)—Lotteries accounts for 40% of Tabcorp's EBITDA, and Lotteries has had its best run in jackpot activity with prize pools up 49% in FY19YTD, supported by Powerball, which has already seen one jackpot above A$100m.

The top stock detractors were:

- Suncorp Group (ASX:SUN)—Disappointed investors with small hazard claims around 50% above their historical average, weighing on profitability.
- SEEK (ASX:SEK)—Traded lower on limited newsflow during the month.
- Westpac Banking Corporation (ASX:WBC, no holding)—Shares fell as the banking sector came under pressure from the banking royal commission. The sector is also facing increased competition, higher funding costs and slowing credit growth. However, the stock still finished the month higher than its peers and the index as a whole.

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 Income Portfolio has an investment style best described as 'style neutral' with above-average income and associated franking credits. The security selection process has a strong bottom-up discipline and focuses on buying quality businesses at reasonable prices.

The Australian Equities Income Portfolio also has a preference for securities that have high and sustainable dividend capability, strong profit-to-cash conversion, and relatively assured earnings growth. Securities that generate franking credits predominate.

We define quality businesses as being those with the following six attributes:

- earnings strength (particularly improving return)
- superior industry position
- a sound balance sheet
- strong management
- low environmental, social and governance (ESG) risk
- Income sustainability / growth

The focus of the portfolio is on yield. We are focused on a growing, sustainable dividend yield above the market.

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 Panorama (Direct, Compact and Full)
- Coloinal First State FirstWrap
- Federation Alliance
- HUB24
- Linear
- Macquarie Wrap
- Mason Stevens
- Netwealth
- OneVue
- Powerwrap
- Praemium

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