Australian Equities Income Portfolio

Performance Report – May 2018

Market overview and portfolio performance

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Following a strong rally in April, the S&P/ASX 200 Industrials Accumulation Index (the portfolio's benchmark) put on a modest 0.72% for the month. Health Care, Consumer Discretionary, Real Estate and Information Technology outperformed. Utilities and Industrials were broadly in-line. Telecommunication Services was the largest underperformer, mostly dragged down by Telstra Corporation (ASX:TLS) on the back of weak earnings guidance and talk of dividend cuts.

The portfolio's dividend yield expectation for 2018 is currently 5.03% (6.18% grossed up for franking credits) suggesting ~10% growth in dividends on 2017, although the growth outlook is better for other financials and cyclicals compared to defensives and banks. Several dividends were received in May, representing approximately 18.7% of the forecast dividend yield for 2018. A further 0.4% is expected to go ex-dividend during June.

Portfolio overview

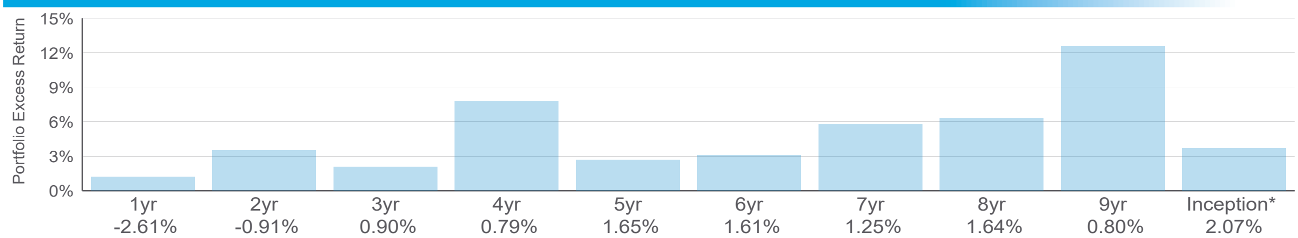
Investment bias	Style neutral
Designed for	Investors who seek a greater level of income and who can make use of franking credits
Benchmark	S&P/ASX 200 Industrials Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Industrials Accumulation Index and deliver higher levels of income (before fees) over a rolling three year period
Investable universe	ASX listed securities with a focus on S&P/ASX 200 and ASX listed convertible securities
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

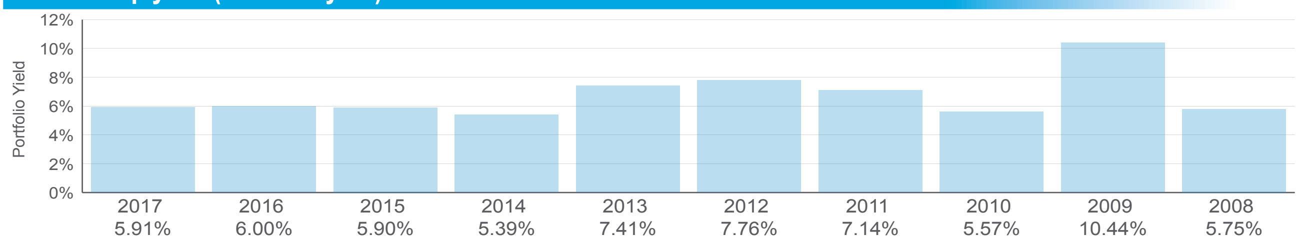
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	Incep.* %
Income Portfolio	-0.37	-0.27	-1.44	2.38	5.81	11.16	12.86	7.21
S&P/ASX 200 Industrials Accumulation Index	0.72	-0.47	0.04	4.99	4.91	9.51	11.61	5.14
Excess Return	**-1.09**	**0.20**	**-1.48**	**-2.61**	**0.90**	**1.65**	**1.25**	**2.07**

** 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

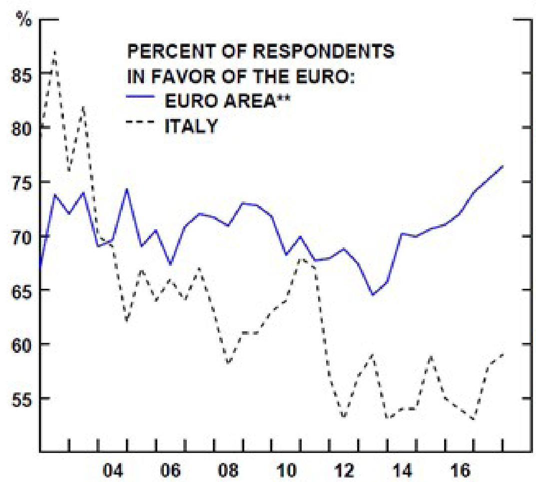
While most markets ended the month up in absolute terms, May saw geopolitical risks once again bubble to the surface. The roundabout of Italian politics looks set to continue with the interim government on shaky ground, while global trade tensions continue to rise. This month we will explore these issues 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 European Union (EU). While support for EU membership remains above 50%, it is important to consider the underlying drivers of anti-EU sentiment.

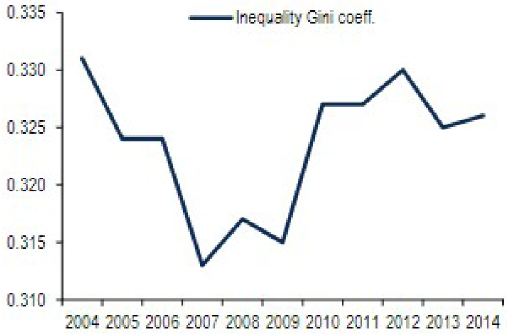
Italian voter support for euro



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.

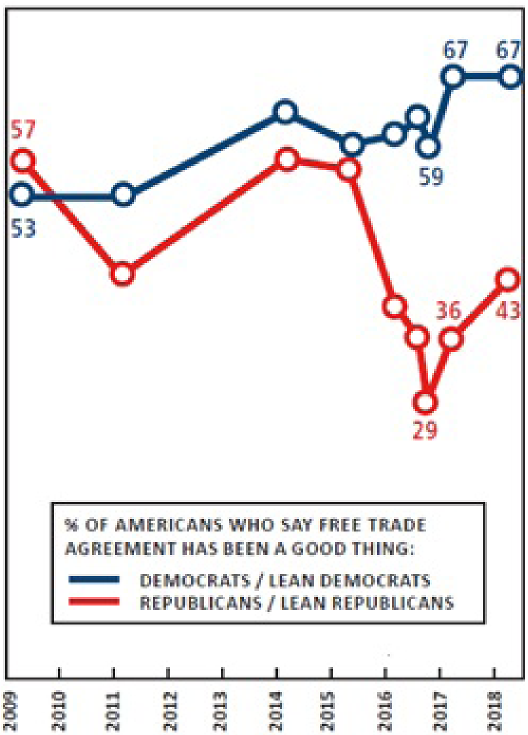
The volatile political situation is leading to more conservative positioning in financial markets. We have already seen money flowing into US treasuries with the US 10-year bond yield falling back under 3%. The sustainability of the move will depend on near-term news flow, however the longer-term outlook 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 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



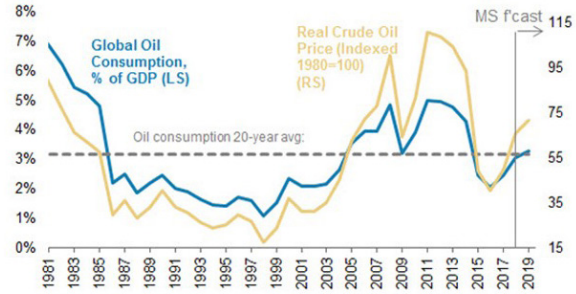
Source: Pew Research

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 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.

Portfolio positioning

Australia is likely to remain a laggard in a global context, given higher household debt, slower consumer growth and a vulnerable housing market. However, we still see pockets of value. In addition, the dividend on equities remains attractive relative to other asset classes and consequently we think it continues to attract interest.

Our current portfolio 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); and
- 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%,18bps above the benchmark despite our underweight positioning in banks, property trusts, utilities, infrastructure and telecommunications. No dividends were received in May, however dividends representing approximately 18.7% of the forecast dividend yield for 2018 went ex-dividend in May and will be received in July. A further 0.4% is expected to go ex-dividend during June.

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; and
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—Atlas Arteria (ASX:ALX), SEEK (ASX:SEK).

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), Insurance Australia Group (ASX:IAG).

Portfolio moves

Banks

We have exited our position in Westpac Banking Corporation (ASX:WBC) and switched to Commonwealth Bank of Australia (ASX:CBA, not previously held). This is largely to take advantage of the fact that WBC went ex-dividend on 17 May 2018 and we can collect another dividend from CBA in August 2018. In addition, the relative valuation between CBA and WBC is currently immaterial, reducing the risk of such a trade. We are also conscious of having too much retail bank exposure with the ongoing pressure on the consumer, over-leverage and housing risks. National Australia Bank (ASX:NAB) remains our preferred bank exposure. We retain a 5% underweight position in the sector.

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

1. Industry structure—While their oligopolistic powers may have peaked, the major banks retain a strong market position. In the past 10 years, the majors have used their oligopoly pricing power effectively, particularly in the mortgage market where they have repriced headline rates on owner occupier and investor loans. CBA has a dominant brand and a higher return on equity (ROE) than peers.
2. Management—CBA currently has about five senior management roles vacant, which potentially acts as a distraction in the short term. However it represents an opportunity for meaningful change in the medium term under the leadership of new CEO, Matt Comyn.

3. Earnings strength—We expect low- single digit growth in CBA's underlying earnings in the medium term, underpinned by a subdued but relatively stable economic outlook; mid-single-digit volume growth; higher margins; positive jaws; rising loan losses and further capital build.
4. Balance sheet—CBA's Common Equity Tier (CET) ratio is currently ~10.4%. Subject to the outcomes from the Royal Commission, a buyback is possible in FY20, or as early as FY19.
5. Dividend sustainability—Despite the earnings headwinds, CBA's dividend should continue to be supported in the medium term.
6. Environmental, social and governance (ESG)—The company has a medium ESG exposure. We see potential for adverse impacts from the Royal Commission and other inquiries into conduct and pricing.

Further revelations at the Royal Commission have caused further weakness in the sector. The heavy scrutiny of the press can cause investors to inflate the issues at hand. The key issues include:

- The potential for a credit crunch to impact the economy. It is significantly more difficult to get lending now and this increases the risk of a hard landing in the property market. However, regulators are well aware of this and have taken some steps to reduce the pressure like removing investor lending caps of 10% growth.
- Remediation and the risk of financial penalties. Most of the financial planning issues had been well covered prior to the Royal Commission but we expect there will be a requirement to accelerate remediation. The bigger risk is in the event of a downturn and that in the event of a pick-up in bad debts, defaulters might sue on the basis of irresponsible lending. This could deepen the next downturn.
- Slower loan growth going forward and a greater need to accelerate cost out.
- Further sentiment weakness on the back of business lending stories that are about to emerge in the new phase of the Royal Commission. The issue here will be banks pulling lending from businesses once the GFC started. Any shift in requirements for the banks has significant potential to alter risk appetite of the banks. We think the government will tread lightly here.
- Overall the banks offer modest profit growth but attractive dividends. We do not see the dividends at threat. The capital growth on offer looks modest with downside risk in the event of the risks identified above. We remain underweight with our financials exposure assisted by positions in Macquarie Group (ASX:MQG) and CYBG (ASX:CYB), which are not impacted by the Royal Commission.

The misconduct revelations at the Royal Commission, questions over bank lending standards, looming regulatory changes and potential fines have seen the banks left on decade-low multiples. However, the discount can be justified given the minimal earnings growth outlook and potential earnings deterioration. While consensus expectations are for revenue growth to exceed cost growth (positive jaws), it is possible that banks could experience 'negative jaws' (higher cost growth than revenue growth) given the revenue headwinds from falling loan growth and increasing competition, unable to be easily offset by cost reductions.

Our expectations for flat earnings per share (EPS) growth remain. This is largely in the price with sector valuations fair and dividend yields attractive. However, it is difficult to see the sector outperforming with the overhang of the Royal Commission. In addition, while the sector can usually be expected to be a beneficiary in a rising interest rate environment, we are cautious about the consumers' exposure to high household debt. Our preferred bank remains NAB, given it is investing, has higher growth and the cheapest price-earnings ratio (PE).

Purchase of Link Administration Holdings (ASX:LNK)

LNK is a technology-enabled provider of outsourced administration services for super fund administration, corporate markets and related value added services including data management analytics, digital communication and stakeholder education and advice. A recent opportunistic acquisition in the UK (Capita Asset Services) from a forced seller has seen it acquire a similar business. It will look to apply its expertise and systems to drive improvements in this market and provide another growth lever.

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

1. Industry Structure—LNK has a dominant market position in superannuation administration in Australia (35% with the next biggest share 8%) and the number two position in share registries and a strong position in funds administration in the UK.
2. Management—John McMurtrie joined LNK in 2002 as Managing Director. John's previous senior appointments include Executive General Manager of ASX's Investors and Companies division. He is a strong, experienced CEO with $100m worth of equity driving alignment.
3. Earnings Strength—LNK earns attractive margins and returns from its dominant market position. Cashflow is attractive and earnings consistent.
4. Balance Sheet—Recent capital raising has improved LNK's balance sheet and reduced net debt / earnings before interest, tax, depreciation and amortisation (EBITDA) to ~1.5x.
5. Dividend Sustainability—LNK has a dividend payout ratio of ~50% which is sustainable and growing in-line with EPS growth of ~10% pa.
6. Environmental, Social and Governance (ESG)—LNK is among the top quartile of companies from an ESG perspective.

After delivering a strong result in February the stock has de-rated sharply driven by three factors:

1. Selling from a number of fund managers who lost mandates which soaked up a large amount of the demand for the company.
2. A surprise capital raising by the company which, when combined with the selling above, created an overhang as the market needed to absorb significant stock.

3. A surprise budget announcement to reduce the number of super fund accounts with less than $6k, that have been dormant for 13 months and include no life insurance. At face value this is negative to earnings and LNK has outlined a worst case scenario which amounts to ~10% of earnings. However there will be mitigants—political lobbying may seek to extend the time an account is inactive from 13 months to a longer time frame, super funds may seek to ensure smaller accounts remain active or have life insurance, the company has the ability to lift prices if the number of super fund accounts fall, and extra services will be sold to super funds to increase member engagement. We expect the worse case outcome is ~5%. In the longer term it will also place pressure on those funds that insource their administration which could create opportunities for LNK to win share.

With the market overreacting to the negative news we have used the opportunity to build a position in the company.

We see upside from three areas:

1. Winning share in super administration. LNK is the cheapest player in the market due to a scale advantage by some margin. Given a greater focus on efficiency and price we would expect this to translate into market share over time. The market has not factored in much for market share upside given it has lost a couple of accounts in recent years. However, we see opportunities in the long term given its strong position.
2. Margin upside. LNK acquired Superpartners, which was initially dilutive to margins. Based on the prospectus it was expecting margins to return to their pre-Superpartner levels of 34%. We expect there was an element of conservatism here given the greater scale should drive better margins. The market is at 34%.
3. Integration of the UK and further acquisitions. Capita Asset Services in the UK was the number three player. With LNK's expertise and global capability it will be in a better position to compete for larger clients. We further expect further consolidation in funds administration and share registries.

Key risks

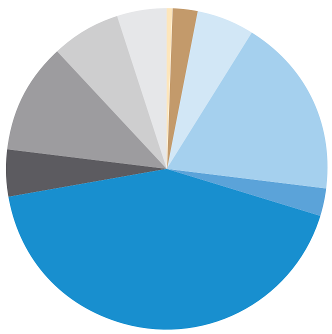
The key risk is more aggressive regulation driving faster-than-expected member consolidation. We are forecasting the number of members compared to the working population declines from circa 1.35x to 1.0x over the next few years. There is some possibility regulation will drive faster consolidation. However, we would expect the larger funds to benefit more in this environment, which will lessen the impact on LNK.

Conclusion

The stock is trading at 13x FY20 which appears cheap given the quality of the business, potential upside to earnings and global comparisons. There is a further 50 cents worth of possible value in PEXA (an unlisted electronic mortgage conveyancing business expected to list next year), which reduces the multiple to 12x and a further 5% upside to earnings if $500m were deployed in a value-creating acquisition. Earnings are defensive with inflation escalators and an annuity stream of income. As a consequence, we believe it will trade at a premium to the market. We expect the stock to re-rate as it wins new customers providing the market with greater confidence over the revenue outlook and as it delivers synergies.

Portfolio attribution

Sector weightings %



Source: DNR Capital

12 month - top contributors and detractors

Top 5 contributors		Alpha*
Commonwealth Bank of Australia	Underweight	0.77%
Macquarie Group	Overweight	0.66%
Telstra Corporation	Underweight	0.66%
Lendlease	Overweight	0.62%
Bank of Queensland	Overweight	0.44%
Top 5 detractors		
CSL	No Holding	-1.85%
Tabcorp Holdings	Overweight	-0.95%
Aurizon Holdings	Overweight	-0.89%
IOOF Holdings	Overweight	-0.84%
Brambles	Overweight	-0.49%

Monthly - top contributors and detractors

Top 5 contributors		Alpha*
IPH	Overweight	0.68%
Westpac Banking Corporation	Underweight	0.35%
Commonwealth Bank of Australia	Underweight	0.20%
Lendlease	Overweight	0.16%
Macquarie Group	Overweight	0.15%
Top 5 detractors		
CSL	No Holding	-0.49%
Brambles	Overweight	-0.32%
MYOB Group	Overweight	-0.27%
Aurizon Holdings	Overweight	-0.19%
CYBG	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.
- Westpac Banking Corporation (ASX:WBC)—Underweight position in WBC added to performance. WBC delivered a 1H18 result with cash earnings of $4,251m, broadly inline with market expectations. This represents growth of 5% on the prior period.
- 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%.

The top stock detractors were:

- CSL (ASX:CSL, no holding)—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.
- 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 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
- Colonial First State FirstWrap
- Federation Alliance
- HUB24
- Linear
- Macquarie Wrap
- Mason Stevens
- Netwealth
- OneVue
- Powerwrap
- Praemium

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