Australian Equities Income Portfolio

Performance Report – October 2017

Market overview and portfolio performance

Equities soared during October, which has historically been a difficult month of the year. Improving economic growth, a strong US reporting season, greater confidence around US tax cuts and positive central bank signalling helped propel markets higher. In Europe, economic conditions surged to their highest level in 17 years, despite rising political concerns in Spain. The Eurozone's industrial sector is now running at its best level since 2000, with cyclical industries like construction showing a strong rebound.

The ASX 200 Industrials Accumulation index closed +3.89%. All sectors were recorded positive contributions for the month. Australia continues to lag global markets given an almost zero weight to IT and a very large (and underperforming) bank sector. The 12-month forward dividend yield is 4.75% (6.23% grossed up), suggesting little growth in dividends. The growth outlook is better for Other Financials and Cyclicals, compared to the Defensives and the Banks. Bond yields have tracked sideways, supporting the advance in equity markets and whilst there is arguably some buffer for equities, the emergence of higher inflation and an increase in bond yields remains the key risk.

The DNR Capital Australian Equities Income Portfolio outperformed its benchmark by 1.02%.

Portfolio overview

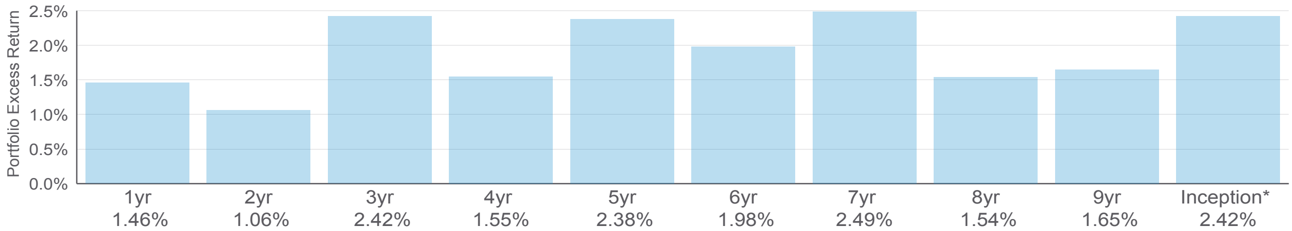
Investment bias	Style neutral
Designed for	Investors who seek a greater level of income and who can make use of franking credits
Benchmark	S&P/ASX 200 Industrials Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Industrials Accumulation Index and deliver higher levels of income (before 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
Investment timeframe	5 years
Portfolio managers	Jamie Nicol (Chief Investment Officer) Scott Kelly (Portfolio Manager)

Gross active return

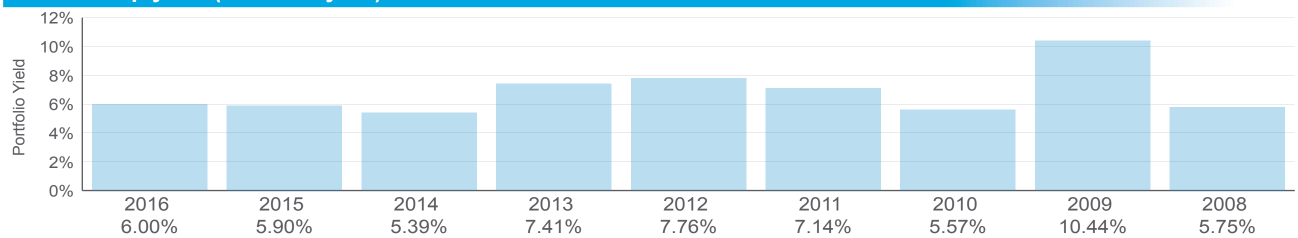
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	Incep.* %
Income Portfolio	4.91	4.26	0.99	16.36	10.27	15.19	14.22	7.73
S&P/ASX 200 Industrials Accumulation Index	3.89	3.91	-0.04	14.90	7.85	12.81	11.73	5.31
Excess Return	**1.02**	**0.35**	**1.03**	**1.46**	**2.42**	**2.38**	**2.49**	**2.42**

** Inception date—December 2007*

Annualised excess return



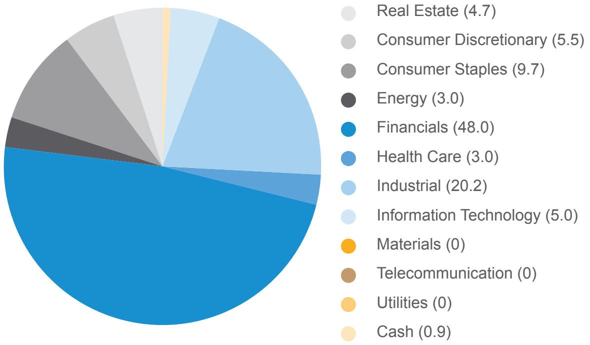
Grossed-up yield (calendar year)*



**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.

Sector weightings %



Source: DNR Capital

12 month - top contributors and detractors

Top 5 contributors		Alpha*
Telstra Corporation	Underweight	1.58%
IPH	Overweight	0.63%
Fairfax Media	Overweight	0.45%
National Australia Bank	Overweight	0.42%
Macquarie Atlas Roads	Overweight	0.40%
Top 5 detractors		
Brambles	Overweight	-1.14%
CSL	No Holding	-0.90%
Healthscope	Overweight	-0.78%
Cash	Overweight	-0.41%
Qantas Airways	No Holding	-0.40%

Monthly - top contributors and detractors

Top 5 contributors		Alpha*
IPH	Overweight	0.76%
Healthscope	Overweight	0.32%
ANZ Banking Group	No Holding	0.19%
Macquarie Atlas Roads	Overweight	0.18%
MYOB Group	Overweight	0.15%
Top 5 detractors		
Lendlease	Overweight	-0.60%
Cash	Overweight	-0.11%
Aristocrat Leisure	No Holding	-0.09%
a2 Milk Company	No Holding	-0.09%
Treasury Wine Estates	Underweight	-0.08%

** 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:

- IPH (ASX:IPH)—Acquired New Zealand intellectual property firm AJ Park. The acquisition is accretive with substantial opportunity to lift margins.
- Healthscope (ASX:HSO)—Shares have begun the rebound as the market looks through difficult private hospital conditions.
- Australia and New Zealand Banking Group (ASX:ANZ)—Headline FY17 cash earnings of $6.94b were broadly in line with expectations, although the result was supported by a lower bad debt charge. The weaker underlying performance was impacted by normalisation of trading income, which now appears to be tracking at sustainable levels.

The top stock detractors were:

- Lendlease (ASX:LLC)—The company provided an update including expectations for a weaker 1H18 construction performance. It indicated FY18 will be impacted by underperformance in Australian construction, which relates to a small number of engineering projects. This will be affected by a stronger performance in development.
- Cash—The portfolio's cash weighting detracted from performance given strong gains in the market.
- Aristocrat Leisure (ASX:ALL, no holding)—Shares traded higher driven by ongoing market share gains.

Market review

In recent months DNR Capital has focused on the risks to the market, which we will reiterate this month. However, we thought it would be useful to also highlight where we are seeing market opportunities.

Risks

We continue to closely watch the potential for inflation to rise. Low inflation has driven low interest rates, which has supported high asset prices especially for defensive assets. Any change in this regard has important consequences for markets. 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 miss-steps as populist politicians seek to appease the electorate. Geopolitical risks (North Korea, Middle East) always present potential risks, especially when valuations are steadily rising, complacency appears to be rising, and volatility remains low.

Australia has lagged global indices over the past year by circa 7%. The Australian economic recovery appears to be a little behind global markets and some larger companies are facing structural or company-specific headwinds. Examples include:

- Telstra Corporation (ASX:TLS) facing pressure in mobiles and from the NBN
- Commonwealth Bank of Australia (ASX:CBA) facing conduct issues
- Retail property trusts facing pressure from Amazon
- AMP (ASX:AMP) cancelling buyback and increasing spend to retain funds under advice.

Considering this, we thought it appropriate to focus on the areas of the market where we are finding opportunities (by no means exhaustive).

Opportunities

Global Growth

Global growth has accelerated over the past year with Europe and the 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 is feeding into higher commodity prices and offers a pickup in resource-related capex. The mining sector has been raising capital and repaying debt, leaving it well placed to increase capex.

Furthermore, capex has fallen sharply in recent years. The oil and gas sector capex spend has halved. The market is generally forecasting a modest pickup 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, Qube Holdings (ASX:QUB) as well as major resource companies that will benefit from a pickup in resource-related spending.

In addition, the strength of the US economy and moderate signs of a potential pickup in wage inflation should support globally exposed companies like Brambles (ASX:BXB).

US Tax Cuts

Current US government plans are for a cut to the corporate tax rate from 35% to 20%. While there are doubts this level will be achieved because it will be difficult to find sufficient revenue offsets that are politically acceptable, the political consensus (among Republicans) appears stronger for tax cuts than for healthcare changes. We expect some outcome that is positive for tax cuts.

The precise impact on corporates is somewhat difficult to isolate, because there are a range of offsets. For example, corporate net interest deductibility would be limited to 30% of Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA). DNR Capital is invested in a range of companies that earn more than 20% of their earnings in the US and consequently should benefit from these tax changes. Potential beneficiaries include Macquarie Group (ASX:MQG), Brambles (ASX:BXB), Lendlease (ASX:LLC) and Janus Henderson Group (ASX:JHG).

Internet Models

A notable development in recent years has been the use of captured data by companies to expand their addressable market. Brambles (ASX:BXB) is exploring the value of its tracking data on the movement of inventory, and retailers are seeking a greater understanding of their customers to increase sales. An example of this is Woolworths (ASX:WOW) introducing targeted promotions to its customers.

Software models

With the increase in use of smart phones and the advances in internet speeds and storage, we have seen acceleration in the use of Software as a Service (SaaS) models. These offer software services delivered over the internet. Typically they involve a monthly payment for the services. The attractions for these businesses include a monthly revenue stream and the ability to embed the offering into a client's business. Furthermore, once you have a market leading platform there is the opportunity to export the offering. These are very attractive attributes. Examples of companies using this model are IRESS (ASX:IRE) and MYOB Group (ASX:MYO).

Fund Manager Models

Like the software models, we are attracted to fund manager businesses like Janus Henderson Group (ASX:JHG) and Macquarie Group (ASX:MQG). The attraction stems from the annuity stream of earnings, the ageing population seeking solutions for their savings, and the leverage their earnings have to this growing pool of savings. Macquarie Group remains a market leader in infrastructure funds management, while Janus Henderson Group can leverage a strong acquisition.

Inflation Hedges

Given our concerns regarding the potential for inflation to rise, we are focused on companies that perform well in an inflationary environment. Quality companies with pricing power are typically well placed. Companies like Woolworths (ASX:WOW) have either inflation-escalator clauses in their contracts or strong pricing power.

Infrastructure Spending

The populist political environment is likely to drive an increase in infrastructure spending. Australia is already enjoying a pickup and companies like Lendlease (ASX:LLC) should enjoy the benefits (notwithstanding Lendlease's construction division miss-steps).

Portfolio moves

Purchase of IOOF Holdings (ASX:IFL)

IOOF's acquisition of ANZ Wealth significantly increases its scale and competitive position in advice and platforms. We see significant synergies attached to the transaction. IOOF is yielding 5% fully franked and this dividend should grow as it executes the transaction. Consequently, we have added it to the Income Portfolio.

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

1. Industry Structure—industry structure has improved significantly following the ANZ Wealth transaction. Post the deal, it will be a clear number two in advice and will be well placed to pick up disaffected advisers from the major banks. The deal is transformative because it effectively doubles its size in funds under advice (FUA) and in terms of adviser numbers-significant scale benefits.
2. Earnings Strength—Earning outlook appears strong with synergies from integrating the two businesses estimated at 11% of combined cost base. Other deals have historically been more than 20%. There is nothing allocated for revenue opportunities like using scale to improve margins on its platform product.
3. Balance Sheet—Using strong balance along with raising to fund the ANZ deal, gearing is modest at 1.3x the combined EBITDA (excluding synergies).
4. Management—Christopher Kelaher is the Managing Director. He has extensive capital markets experience from his time with Citicorp.
5. Environmental, social and governance (ESG)—no material ESG risks.

An interesting change in the market is occurring. With the majors' appetite for advice waning, IOOF is emerging in a leadership position. The ANZ dealer group brands (millennium3, Elders Financial Planning, RI Advice and Financial Services Partners) have reasonably low average FUA. Based on the numbers in its investor presentation we estimate the average funds under management (FUM) per adviser to be ~$27m (717 advisers with $19.5b FUA). This should result in:

- advisers being less likely to consider the independent licensee route given their smaller size (which would have resulted in loss of dealer fees, platform FUM and internal investment product FUM). This will help with retention and if an adviser leaves the licensee the FUM impact is at the margin.
- advisers being more likely to adopt new product initiatives from IOOF (given the cost effectiveness gained because of IOOF's scale).
- advisers being more reliant on the dealer group services given their size/resources.
- more value attributed to the cost benefits of being associated with a big brand like IOOF.

Key risks

Next year there are risks around extraction of the wealth business from ANZ. The two platforms are not the strongest and will need investment (which might mean it reinvests cost savings in excess of budget).

Valuation

The stock is at circa 18x next year, so not that cheap. However, there is a clear path for growth that the market will like. If we adjust for synergies it is more like 14.5x, which appears attractive given the improved competitive position.

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 five attributes:

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

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

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