Australian Equities Income Portfolio

Performance Report – January 2019

Market overview and portfolio performance

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The S&P/ASX 200 Industrials Index was up 2.56% in January, rebounding after two months of heavy losses although still underperforming international markets. Information technology (9.3%) outperformed, recovering some of its losses from previous months as much of the pessimism surrounding the US Federal Reserve (the Fed) tightening was unwound, with the Chair Jerome Powell's comments signalling a softening stance on policy. The hint of lower rates, coupled with a flight to safety, saw traditional bond proxies like A-REITs (6.2%) and Utilities (6.0%) move higher. Financials (-0.2%) were the biggest drag on the index, as banks continued to struggle against significant headwinds.

The DNR Capital Australian Equities Income Portfolio outperformed its benchmark for the period.

The portfolio is currently positioned to deliver a dividend yield for 2019 of 5.0% (6.6% grossed up for franking credits).

Portfolio overview

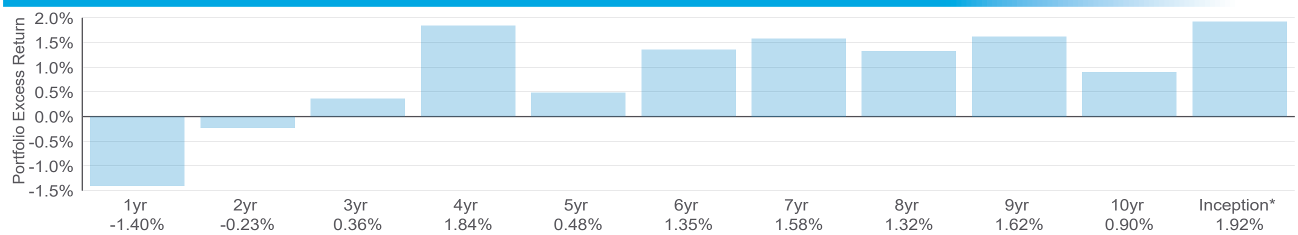
Investment bias	Style neutral
Designed for	Investors who seek a greater level of income and who can make use of franking credits
Benchmark	S&P/ASX 200 Industrials Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Industrials Accumulation Index and deliver higher levels of income (before 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

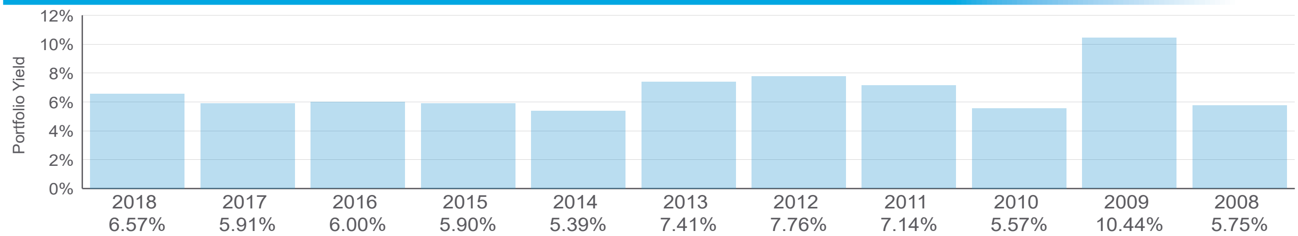
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Income Portfolio	2.66	-3.36	-7.88	-2.43	6.95	7.88	13.41	12.56	6.64
S&P/ASX 200 Industrials Accumulation Index	2.56	0.02	-5.90	-1.03	6.59	7.40	11.83	11.66	4.72
Excess Return	**0.10**	**-3.38**	**-1.98**	**-1.40**	**0.36**	**0.48**	**1.58**	**0.90**	**1.92**

** 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

Banking royal commission

The banking royal commission—not as bad as feared for the banks

The banking royal commission's final report and government's response removes a tail risk for the industry. Reviewing the key recommendations, we believe the report is not as bad as feared and provides certainty on the operating environment going forward. Key areas that the market was concerned about included:

1. Structural separation. The commissioner has not recommended the structural separation of the financial organisations. However ANZ Banking Group (ASX:ANZ), Commonwealth Bank of Australia (ASX:CBA) and National Australia Bank (ASX:NAB) are all in the process of divesting wealth, but Westpac Banking Corporation (ASX:WBC) will likely retain its business.
2. Remuneration. Changes suggest boards must take into account non-financial measures and review annually. This is being implemented in any event.
3. Responsible lending. Probably the most negative aspect of the report, with a tightening of checks of customers' expenses and income that could further restrict credit.
4. Greater powers for the Australian Securities and Investments Commission (ASIC), as expected.
5. Mortgage broker commissions potentially to be paid by borrower, and trailing commissions to be banned. This is a negative for mortgage brokers but should be helpful for banks as it will limit competition.

However, while we have seen a rebound in bank share prices, there are a range of issues that will continue to overhang them:

- We remain concerned about remediation, the risks of financial penalties, and litigation (in particular it is difficult to assess the quantum of potential loss from irresponsible lending).
- 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 exposure to, and headwinds from, Australia's property market.
- The wholesale funding environment seems to have deteriorated in recent weeks.
- Compliance costs will increase as banks seek to ensure these mistakes are not repeated.
- While bad debts remain at record lows, these can only be headwinds going forward.
- Uncertainty regarding the level of capital required.
- Growth outlook for the banks remain limited, albeit long term there is still a cost-out opportunity.
- The incremental buyer of the banks are offshore investors and it is likely that Australian dollar weakness will keep them on the sidelines.

We remain underweight the big four banks with our financial exposure assisted by positions in Macquarie Group (ASX:MQG), Suncorp Group (ASX:SUN) and CYBG (ASX:CYB).

Reporting season preview/expectations

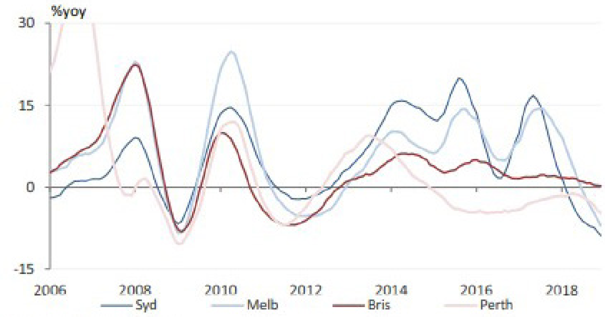
Ahead of reporting season, we identify these key themes.

How is housing downturn affecting company earnings?

We expect the market to focus on any management commentary that highlights the impact of slower housing on earnings. Confession season (companies updating guidance ahead of reporting earnings) has been weak with a 5:1 skew towards downgrades. In large companies, downgrades have been concentrated in companies with housing and consumer exposures.

The housing downturn continues with national house prices down ~10% during 2018.

Housing markets softening in Sydney, Melbourne while Perth remains weak



Source: CoreLogic, Morgan Stanley Research

Housing stocks have underperformed the market by ~15% since 2017, albeit this has largely been driven by the underperformance of the banks.

Housing-related stocks have underperformed 15% since 2017

Source: FactSet, UBS, Housing-related stocks defined as ABC, ANZ, BEN, BLD, BOQ, CBA, DLX, JHX, MGR, NAB, REA, SGP & WBC, cap-weighted and free float adjusted

Domestic outlook softening?

The domestic backdrop clearly softened during 2H18, evident in economic data and recent company guidance downgrades (companies exposed to discretionary retail). Business sentiment has deteriorated, employment growth has moderated and the housing sector (residential building approvals, credit growth, house prices, etc) continues to cool. The consumer has held up so far, however uncertainty remains and risk is to the downside. Christmas trading appears to have been weak, consumer sentiment has been softer, tourist arrivals have been slowing, new car sales have seen significant falls and house prices continue to deteriorate. RBA Governor Phillip Lowe is also less bullish. He recently gave a dovish speech titled 'The Year Ahead', where he made clear the RBA has changed its own view on the outlook for the cash rate to 'neutral'.

Will dividends and capital management continue to surprise on the upside?

With gearing levels close to all-time lows and more attractive valuations following the recent market correction, there is some potential for capital management surprises (higher dividends, special dividends, buybacks). In addition, there is potential for companies to react ahead of the forthcoming election, the Australian Labor Party's (ALP) likely win and its proposed franking scale-back. Stocks like Wesfarmers (ASX:WES), Woodside Petroleum (ASX:WPL) and Commonwealth Bank of Australia (ASX:CBA) are prime candidates in our view.

The price to earnings ratio (PE) dispersion remains high. How will the market react to hits and misses for loved and unloved stocks?

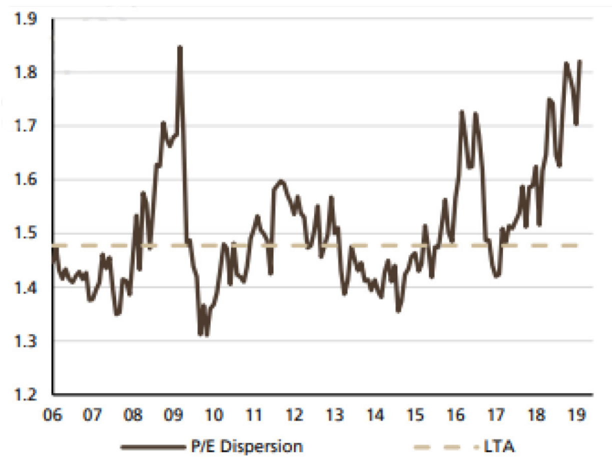
With volatility returning, how the market treats 'hits' and 'misses' of both 'loved' and 'unloved' stocks will be another key feature. While the ASX 200 Industrials Index (the portfolio's benchmark) is trading at a 12-month forward PE of ~15x, broadly in-line with the 20-year average, it is only expected to deliver +4% earnings growth for 2019, compared to 7–8% on average.

ASX 200 Industrials – Latest: 15.2x

Source: RIMES, IBES, Morgan Stanley Research

In addition, PE dispersions have again reached new highs following the financial crisis, primarily driven by the rebound in 'growth' stocks, after their trough in December.

PE dispersion reaches highest since GFC



Source: FactSet, UBS, 80th percentile P/E divided by 20th percentile P/E ASX 100 ex resources, ex infrastructure

Portfolio positioning

Our 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 and cyclically low bad debts.
- 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).

Key risks

- Given valuations have been supported by low interest rates, the emergence of inflation and higher bond yields could be a negative for markets.
- Implications of slowing growth in China, high property prices and high levels of household debt.
- Further geopolitical uncertainty could create negative implications for stocks and portfolios.
- 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—SEEK (ASX:SEK), REA Group (ASX:REA).

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

Cows: Stocks with a solid balance sheet and capital management potential that are being undervalued on traditional earnings-based metrics—IPH (ASX:IPH), Woolworths Group (ASX:WOW).

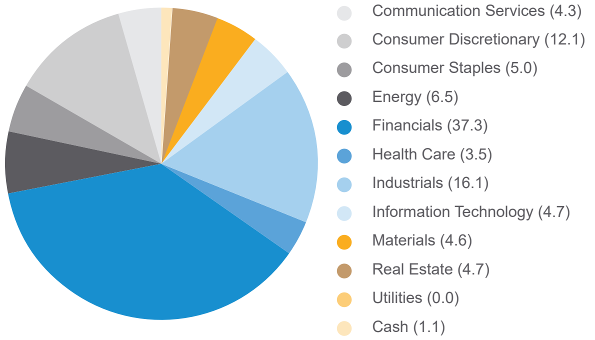
Yielders: Quality companies at attractive valuations that are delivering sustainable and cash-backed dividends, however with little growth—National Australia Bank (ASX:NAB), Telstra Corporation (ASX:TLS).

Portfolio moves

No major changes to the portfolio during January.

Portfolio attribution

Sector weightings %



Source: DNR Capital

12 month - top contributors and detractors

Top 5 contributors		Alpha*
Healthscope	Overweight	0.91%
Westpac Banking Corporation	Underweight	0.79%
AMP	No Holding	0.61%
Brambles	Overweight	0.54%
Commonwealth Bank of Australia	Underweight	0.50%
Top 5 detractors		
CSL	No Holding	-1.87%
CYBG	Overweight	-1.11%
Janus Henderson Group	Overweight	-1.05%
IOOF Holdings	Overweight	-0.62%
Caltex Australia	Overweight	-0.58%

Monthly - top contributors and detractors

Top 5 contributors		Alpha*
Westpac Banking Corporation	No Holding	0.31%
Tabcorp Holdings	Overweight	0.24%
Woodside Petroleum	Overweight	0.21%
SKYCITY Entertainment Group	Overweight	0.18%
Macquarie Group	Overweight	0.16%
Top 5 detractors		
CSL	No Holding	-0.18%
National Australia Bank	Overweight	-0.12%
Commonwealth Bank of Australia	Overweight	-0.12%
Aristocrat Leisure	No Holding	-0.11%
Goodman	No Holding	-0.10%

** 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:

- Westpac Banking Corporation (ASX:WBC, no holding)—Suffered from general negativity around the banks as housing conditions worsened and demand for credit decreased. The market was also positioning for a negative outcome from the banking royal commission report, which was released at the beginning of February.
- Tabcorp Holdings (ASX:TAH)—Had a strong month largely due to the very large Powerball jackpot that peaked during the period. Larger jackpots attract greater inflows and therefore are a tailwind for earnings.
- Woodside Petroleum (ASX:WPL)—Benefited from higher oil prices over the period as reduced global demand, as well as OPEC production cuts and Venezuelan political turmoil, curbed supply. WPL also released a positive quarterly report that reaffirmed guidance.

The top stock detractors were:

- CSL (ASX:CSL, no holding)—Was up during the month as global sentiment improved and healthcare benefited from a move towards bond proxies. The large weight of CSL within the Industrials index positions it as a detractor to performance.
- National Australia Bank (ASX:NAB)—Suffered from general negativity around the banks as housing conditions worsen and demand for credit decreases. The market was also positioning for a negative outcome from the banking royal commission report, which was released at the beginning of February.
- Commonwealth Bank of Australia (ASX:CBA)—Suffered from general negativity around the banks as housing conditions worsen and demand for credit decreases. The market was also positioning for a negative outcome from the banking royal commission report, which was released at the beginning of February.

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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