Australian Equities Income Portfolio

Performance Report – August 2017

Market overview and portfolio performance

August was dominated by geopolitical risks but these failed to deter global equity markets with most of the markets closing in the black. The S&P 500 Index has posted its fifth straight monthly gain. Hurricane Harvey caused devastation to the Gulf Coast with the market looking to relief efforts and companies involved in the rebuild. Asia was a strong performer off the back of continued positive data. Japan was the main casualty as it suffered the consequences of rising North Korean tensions.

The ASX 200 Industrials Accumulation Index closed down 0.25%. Disappointing results came from the insurance and telecommunications sectors. Dividend forecasts were cut by 0.5% in August and almost all of this was attributable to Telstra Corporation (ASX:TLS).

The DNR Capital Australian Equities Income Portfolio underperformed its benchmark by 1.03%.

Portfolio overview

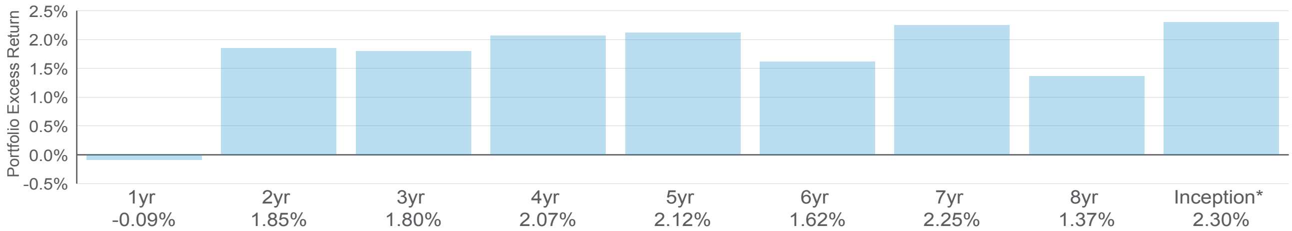
Investment bias	Style neutral
Designed for	Investors who seek a greater level of income and who can make use of franking credits
Benchmark	S&P/ASX 200 Industrials Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Industrials Accumulation Index and deliver higher levels of income (before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

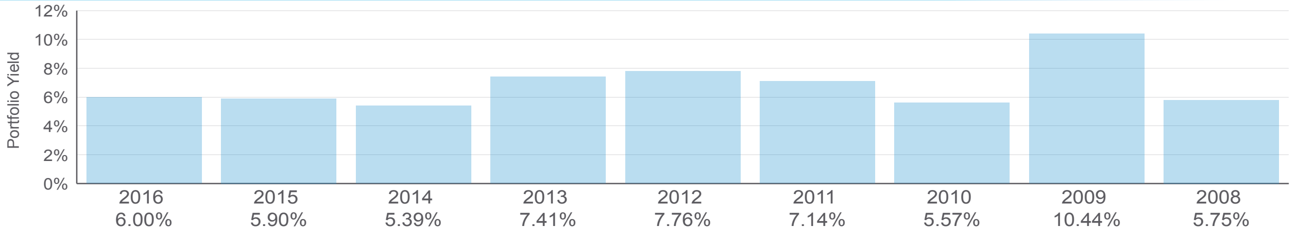
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	Incep.* %
Income Portfolio	-1.28	-2.31	1.88	6.67	8.37	14.91	13.98	7.26
S&P/ASX 200 Industrials Accumulation Index	-0.25	-0.59	1.16	6.76	6.57	12.79	11.73	4.96
Excess Return	**-1.03**	**-1.72**	**0.72**	**-0.09**	**1.80**	**2.12**	**2.25**	**2.30**

** Inception date—December 2007*

Annualised excess return



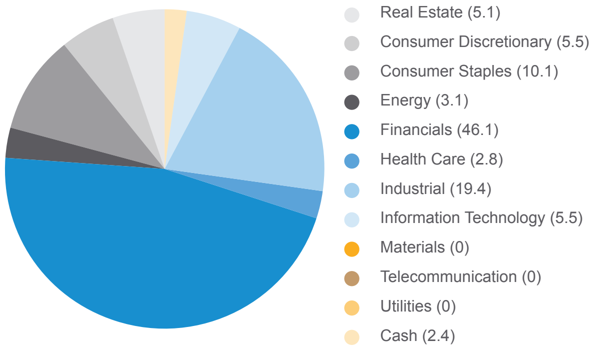
Grossed-up yield (calendar year)*



**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	1.42%
Lendlease	Overweight	0.62%
Scentre	No Holding	0.54%
Westfield Corporation	No Holding	0.50%
National Australia Bank	Overweight	0.42%
Top 5 detractors		
Healthscope	Overweight	-1.84%
Brambles	Overweight	-1.17%
SKYCITY Entertainment Group	Overweight	-0.83%
CSL	No Holding	-0.57%
ANZ Banking Group	No Holding	-0.55%

Monthly - top contributors and detractors

Top 5 contributors		Alpha*
Caltex Australia	Overweight	0.26%
MYOB Group	Overweight	0.14%
Telstra Corporation	Underweight	0.14%
Commonwealth Bank of Australia	Underweight	0.12%
IPH	Overweight	0.12%
Top 5 detractors		
Healthscope	Overweight	-0.56%
QBE Insurance Group	Overweight	-0.24%
IRESS	Overweight	-0.18%
Treasury Wine Estates	No Holding	-0.15%
SKYCITY Entertainment Group	Overweight	-0.14%

** 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:

- Caltex Australia (ASX:CTX)—The company's 1H17 replacement cost of sales operating profit basis (RCOP) NPAT of $307m was up 21%, supply and marketing underlying EBIT up 6% and there was no guidance. It is looking to further cost out measures and other initiatives to replace Woolworth's lost fuel volumes.
- MYOB Group (ASX:MYO)—1H17 revenue was up 14%, underlying EBITDA up 9%, 5% on market buyback. The company delivered a FY17 revenue guidance of 13–15% (slightly above market expectations) and margin guidance of 45–46% (the concern heading into the result was for potential margin disappointment so this was well received by the market).
- Telstra Corporation (ASX:TLS, no holding)—Telstra announced a large cut to its dividend guidance, which saw shares fall.

The top stock detractors were:

- Healthscope (ASX:HSO)—2017 was largely in line but new management guided to a flat FY18 operating EBITDA growth, which disappointed the market expecting 10% growth. We reduced the size of our position but the stock subsequently sold off aggressively and started discounting an overly pessimistic outcome.
- QBE Insurance Group (ASX:QBE)—Underlying margin softness was flagged, prompting the market to reduce estimates towards the lower half of FY17 guidance range. A perfect storm of a soft result, hurricanes and North Korea impacting US$ and bonds sees the stock trading at book value.
- IRESS (ASX:IRE)—1H17 revenue was up 9%, segment profit down 6% driven by higher operating costs. The company continues to guide to strong growth for the year.

Market review

The reporting season was subdued, with a notable lack of obvious drivers for the market. It was very much a stock-by-stock proposition, with resources carrying the market. While companies tended to meet expectations for FY17, a consistent trend was the emergence of reinvestment as a range of companies across resources and industrials seek to invest for future growth after a number of years of subdued investment. The most important theme emanating from the current Australian reporting season was the rise in business investment with opex and capex guided higher. This has resulted in a pullback in earnings expectations of 3% over the next year to 4.5% EPS growth for the ASX 200.

Growth stocks vs value stocks

There was no strong thematic across growth or value. Some growth stocks disappointed, like Domino's Pizza Enterprises (ASX:DMP), CSL (ASX:CSL), SEEK (ASX:SEK) and hospitals, while others like Treasury Wine Estates (ASX:TWE), Cochlear (ASX:COH) and Carsales.Com (ASX:CAR) kicked on. The most common thematic across growth stocks was strong top line growth but a higher level of reinvestment. Perhaps this has been influenced by the sales multiples US tech stocks trade on, where there is a focus on reinvesting for the future. Low multiple stocks were a mixed bag as well, with stocks like Telstra Corporation (ASX:TLS), Suncorp Group (ASX:SUN) and QBE Insurance Group (ASX:QBE) disappointing. Those value stocks with a cyclical component like Qantas Airways (ASZ:QAN) tended to do better, as did stock-specific stories like Lendlease (ASX:LLC) and Janus Henderson Group (ASX:JHG). Perhaps it is not so surprising to see the cyclical stocks performing better, given the rise in capex from a range of companies and governments.

US$ earners

A rising A$ impacted the earnings of US$ earners and impacted outlook statements. However once again the reaction was mixed with poorer results from Computershare (ASX:CPU), Ansell (ASX:ANN) and James Hardie Industries (ASX:JHX) and stronger results from Macquarie Group (ASX:MQG) (1Q), Treasury Wine Estates (ASX:TWE) and Cochlear (ASX:COH).

Defensives

Defensives generally struggled through reporting season (telecommunications, healthcare, infrastructure and some property trusts). Softer bond yields through the month supported this situation to some extent.

Banks

Banks delivered strong results and saw upgrades of 1–2% across the forecast period. This was a result of continued subdued bad debts, lending volumes remaining better than feared and margins responding to the out-of-cycle rate increases. The stronger results have been overshadowed by the Commonwealth Bank's Australian Transaction Reports and Analysis Centre (AUSTRAC) issue and the continued fear of a Royal Commission, as well as concerns regarding the housing market and household debt levels. The outlook for 2018 remains for low, single-digit growth with the bank levy offsetting the margin enhancement. The banks are beginning to focus on enhancing productivity, which is likely to be needed in an era of low-credit growth and bad debts normalising from low levels.

Portfolio moves

No major changes to the portfolio during August.

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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