# Australian Equities Income Portfolio

## Performance Report – February 2018

### Market overview and portfolio performance

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With the return of volatility, global markets retreated 4.14% (MSCI World Index) in February, however Australia fared better as reporting season was generally well received. Heightened volatility saw the benchmark falling up to 4.6% between 2 February and 9 February in response to strong hourly earnings in the US, which may put pressure on inflation and result in higher bond yields. The S&P/ASX 200 Industrials Accumulation Index (the portfolio's benchmark) rose 0.61% for the month. Health Care, Information Technology, Consumer Discretionary and Industrials lagged. Real Estate outperformed, while Utilities, Energy, Financials, Telecommunication Services, Materials and Consumer Staples were broadly in-line.

The portfolio's dividend yield expectation for 2018 is currently 5.04% (6.61% grossed up for franking credits) suggesting little 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 February, representing approximately 22.63% of the forecast dividend yield for 2018. A further 0.47% is expected to go ex-dividend during March.

### Portfolio overview

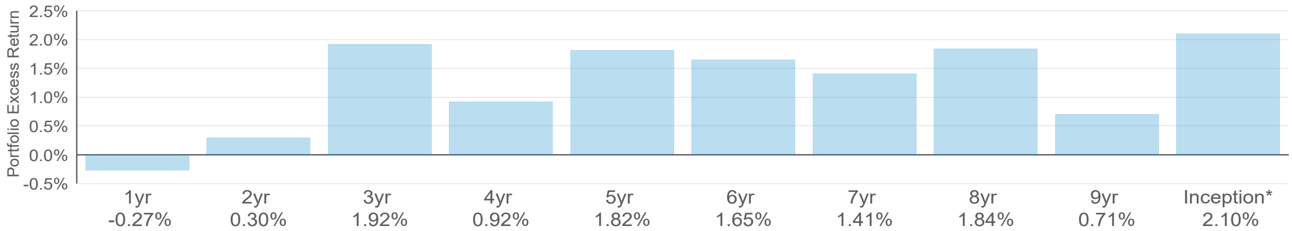
| | |
|---|---|
| Investment bias | Style neutral |
| Designed for | Investors who seek a greater level of income and who can make use of franking credits |
| Benchmark | S&P/ASX 200 Industrials Accumulation Index |
| Investment objective | To outperform the S&P/ASX 200 Industrials Accumulation Index 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%<br>Cash 0–20% |
| Portfolio stock limit | 15% maximum weighting |
| Minimum suggested investment timeframe | 5 years |

### Gross active return

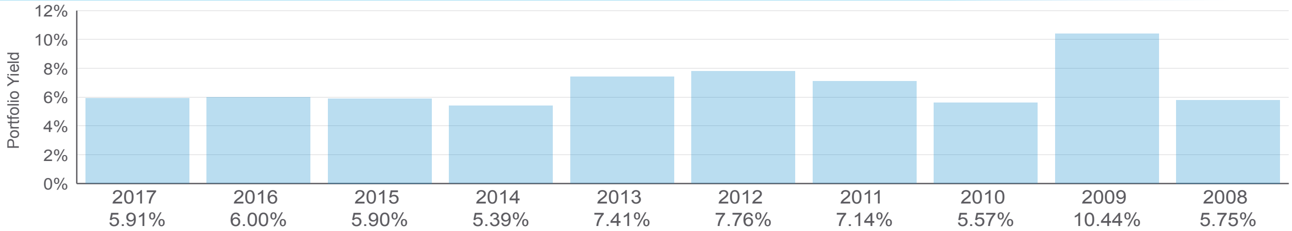
| | 1mth % | 3mth % | 6mth % | 1yr % | 3yr % | 5yr % | 7yr % | Incep.* % |
|---|---|---|---|---|---|---|---|---|
| Income Portfolio | -0.95 | -1.17 | 5.09 | 7.07 | 6.53 | 11.37 | 12.82 | 7.42 |
| S&P/ASX 200 Industrials Accumulation Index | 0.61 | 0.51 | 6.11 | 7.34 | 4.61 | 9.55 | 11.41 | 5.32 |
| **Excess Return** | **-1.56** | **-1.68** | **-1.02** | **-0.27** | **1.92** | **1.82** | **1.41** | **2.10** |

** 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

The DNR Capital Australian Equities Income Portfolio underperformed its benchmark in February by 1.56%.

Key stock contributors were Lendlease (ASX:LLC), National Australia Bank (ASX:NAB) and Insurance Australia Group (ASX:IAG). Key stock detractors were IPH (ASX:IPH), CSL (ASX:CSL, no holding) and Tabcorp Holdings (ASX:TAH).

### Momentum and more 'beats' than 'misses'

Reporting season was broadly positive with a clear trend towards earnings 'beats' relative to 'misses'. We estimate 33% of large caps delivered 'beats', ahead of only 16% delivering 'misses'. However, not all of the 'beats' have translated to earnings per share (EPS) upgrades. For large caps 25% of companies have seen a consensus upgrade of 3% or greater, while 18% have seen a downgrade of 3% or greater.

Momentum was another defining factor in reporting season. Expensive stocks were bid up even further on good results. For example, The a2 Milk Company (ASX:A2M), CSL (ASX:CSL), ResMed (ASX:RMD), REA Group (ASX:REA) and Treasury Wine Estates (ASX:TWE). However, stocks with small misses reacted sharply. For example, Domino's Pizza Enterprises (ASX:DMP), IPH Limited (ASX:IPH) and Blackmores (ASX:BKL).

On the other hand, cheaper stocks underperformed. During the month we took the opportunity to top up a number of portfolio stocks that had underperformed, especially where we gained confidence in the underlying result. These stocks include Suncorp Group (ASX:SUN), Tabcorp Holdings (ASX:TAH) and Macquarie Atlas Roads (ASX:MQA).

### IPH (ASX:IPH) disappoints

For the DNR Capital Income Portfolio, reporting season was generally solid with the exception of IPH, which had negative attribution of 1.12% for the month. IPH reported a 1H18 earnings decline of ~10%, which was below market expectations. While the foreign exchange (FX) negative impact was larger than expected, softer patent filing conditions in Australia/New Zealand (A/NZ) was the primary source of the negative surprise. Management pointed to the impact of the introduction of the America Invents Act, which resulted in a higher number of filings in prior periods, and fewer Chinese inbound filings. IPH's competitors have also noted similar trends during the period. In Australia, IPH maintained #1 market share but industry patent volumes were down ~2%.

We expect 2H18 and FY19 earnings to improve as the A/NZ business reverts back to growth trends experienced in recent years, Asia volumes pick up (strong Nov, Dec and Jan patent filings up 15% on preceding quarter), new acquisitions (AJ Park and HK/China) contribute a further ~$5m by FY19 (they only contributed ~$1m of earnings before interest, taxes, depreciation and amortisation (EBITDA) in 1H18) and losses in the Data Analytics division of $3m are expected to be less in FY19 (with break-even targeted for FY20).

IPH continues to evaluate acquisition and expansion opportunities in the Asia Pacific region, however we believe that the Board should be considering an on-market buyback at current prices. IPH is now trading on a valuation of ~12x (FY18 PE) and a 12-month forward dividend yield of >6%, which is attractive. However, patience is required, but given the strong balance sheet, strong market position and attractive valuation we increased our exposure to IPH as the share price deteriorated.

## Portfolio positioning

Until the first week of February, global markets had enjoyed a very strong run. A positive feedback loop had been created from strong data, low interest rates, contained inflation, company buybacks, exchange traded funds (ETFs) and quant funds. Higher interest rates seem to be the catalyst that has broken this loop, with bond yields on the move and rising. Valuations are expensive in pockets, but the economic outlook is strong. If inflation does not run away, we think the market will buy the dips.

Australia is likely to remain a laggard in a global context. Domestic conditions remain mixed. Housing is rolling over but mining and infrastructure spending is picking up. There are headwinds for consumers as mortgages roll from interest only to principal plus interest and health care, electricity and insurance costs rise. However, pockets of value are still to be found and the dividend on equities remains attractive relative to other asset classes.

Our current portfolio positioning is:

- 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 a 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—Janus Henderson Group (ASX:JHG), Macquarie Group (ASX:MQG)
- Overweight companies that benefit from infrastructure stimulus and resource investment—Lendlease (ASX:LLC), Aurizon (ASX:AZJ)
- Overweight offshore names with >50% of the portfolio earning offshore income to some degree—Brambles (ASX:BXB), Macquarie Atlas Roads (ASX:MQA).

The portfolio's 12-month forward grossed-up dividend yield is 6.61%, 43bps above the benchmark despite our underweight positioning in banks, property trusts, utilities, infrastructure and telecommunications. Aurizon Holdings (ASX:AZJ), Commonwealth Bank of Australia (ASX:CBA), Insurance Australia Group (ASX:IAG), IOOF Holdings (ASX:IFL), IPH (ASX:IPH), Janus Henderson Group (ASX:JHG), Lendlease (ASX:LLC), Suncorp Group (ASX:SUN), Tabcorp Holdings (ASX:TAH), Telstra Corporation (ASX:TLS) and Wesfarmers (ASX:WES) dividends were received in February, representing approximately 22.63% of the forecast dividend yield for 2018. A further 0.47% is expected to go ex-dividend during March.

## Risks

Key risks include:

- as valuations have been supported by low interest rates, the emergence of inflation and higher bond yields could be a negative for markets
- the implications of slowing growth in China, high property prices and high levels of household debt
- any further geopolitical uncertainty creating 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

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—Macquarie Atlas Roads (ASX:MQA), 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 Commonwealth Bank of Australia (ASX:CBA), switched to Australia and New Zealand Banking Group (ASX:ANZ) (not previously held) and increased our exposure to Westpac Banking Corporation (ASX:WBC). This is largely to take advantage of the fact that CBA went ex-dividend on 14 February 2018, and we can collect another dividend from ANZ/WBC when they go ex-dividend in May 2018. In addition, the relative valuation between ANZ, CBA and WBC is currently immaterial, reducing the risk of such a trade. National Australia Bank (ASX:NAB) remains our preferred bank exposure. We retain a 5% underweight position in the sector.

February updates from the major banks were largely consistent with expectations. Favourable margin trends were supported by repricing benefits and improved funding conditions, albeit this was offset by the banks' levy. Asset quality remains sound and solid mortgage volume trends and benign credit conditions also benefited the sector. However, bad debts have bounced off lows, edging slightly higher, although this did not seem to be systemic or sector specific.

Australian Prudential Regulation Authority (APRA) released its discussion paper, which did not appear to result in major capital implications for the sector. ANZ retains a sector-leading capital position. ANZ's Common Equity Tier (CET) ratio, adjusted for announced asset sales yet to settle and the $1.5b share buyback, is 11.3%. This represents a further $3b of surplus capital above APRA's 10.5% line in the sand, so further capital management initiatives remain likely.

CBA's performance was impacted by AUSTRAC-related provisions and a higher-than-expected impairment expense. CBA also absorbed an additional $200m in provisions for compliance and regulatory spend.

The Royal Commission into banks is now underway, with the initial focus on misconduct in mortgages, credit cards and car loans. There have been 73 investigations into the banks since the financial crisis, which have largely had inconsequential outcomes for the sector. However, if the royal commission finds the banks have not lent responsibly, this could open the banks up to class actions, which might have material consequences.

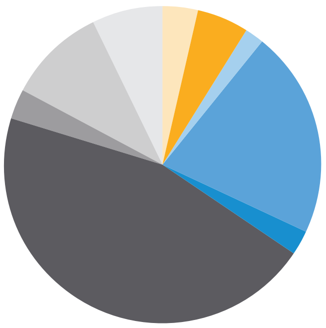
Our expectations for flat earnings per share growth remain. This is largely in the price, with sector valuations fair and dividend yields attractive. However, it is difficult to see the sector outperforming with the overhang of the Royal Commission. In addition, while the sector can usually be expected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

### Sale of IRESS (ASX:IRE)

We have exited our position in IRESS and deployed the funds into a number of stocks already held in the portfolio, including Suncorp Group (ASX:SUN), Tabcorp Holdings (ASX:TAH) and Macquarie Atlas Roads (ASX:MQA). These stocks have underperformed the market but fit our investment thesis, which remains intact.

## Portfolio attribution

### Sector weightings %




*Source: DNR Capital*

### 12 month - top contributors and detractors

| Top 5 contributors | | Alpha* |
|---|---|---|
| Telstra Corporation | Underweight | 0.99% |
| Lendlease | Overweight | 0.73% |
| Janus Henderson Group | Overweight | 0.62% |
| ANZ Banking Group | Underweight | 0.62% |
| Caltex Australia | Overweight | 0.61% |
| **Top 5 detractors** | | |
| CSL | No Holding | -1.36% |
| Tabcorp Holdings | Overweight | -0.73% |
| IPH | Overweight | -0.72% |
| Healthscope | Overweight | -0.69% |
| The a2 Milk Company | No Holding | -0.54% |

### Monthly - top contributors and detractors

| Top 5 contributors | | Alpha* |
|---|---|---|
| Lendlease | Overweight | 0.61% |
| National Australia Bank | Overweight | 0.12% |
| Insurance Australia Group | Overweight | 0.10% |
| Scentre | No Holding | 0.09% |
| Transurban | No Holding | 0.09% |
| **Top 5 detractors** | | |
| IPH | Overweight | -1.22% |
| CSL | No Holding | -0.57% |
| Tabcorp Holdings | Overweight | -0.41% |
| The a2 Milk Company | No Holding | -0.22% |
| Janus Henderson Group | Overweight | -0.20% |

** 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:

- Lendlease (ASX:LLC)—Reported a solid 1H18 result. EBITDA increased 13% to A$721m, with a greater-than-expected engineering impairment more than offset by retirement and military housing revaluations, and solid Barangaroo leasing outcomes lifting the final sale price. Lendlease completed 1,189 apartments in the half with 883 Collins Street and Darling House being the main contributors. Lendlease also announced it will return A$500m of excess capital by way of on market buy-back.
- National Australia Bank (ASX:NAB)—Reported 1Q18 cash earnings of ~$1.65b, 1% lower than 2H17 quarterly average, but 3% higher than the prior corresponding period. This was driven by subdued revenue growth, lower bad debts and an absence of the $500m to $800m of restructuring costs, which will be booked at the 1H18 result.
- Insurance Australia Group (ASX:IAG)—Very strong reported insurance profit and margin (17.3%) boosted by large releases and favourable cat and credit spreads experience. The company boosted its earnings to outlook from the reserve guidance and credit spreads.

The top stock detractors were:

- IPH (ASX:IPH)—Reported 1H18 earnings. Revenue was up 9% to $101.2m but underlying EBITDA was down 3% to $33.2m. Overall the result was softer than expected, reflecting softer patent applications.
- CSL (ASX:CSL)—Underlying net profit after tax (NPAT) of US$1,052m was driven by stronger-than-expected revenue growth for IG, haemophilia, and Seqirus and the company upgraded goals for FY18.
- Tabcorp Holdings (ASX:TAH)—Despite a strong start to the half (+4.5% in 1Q18), wagering and media appear to have declined in 2Q led by weakness in tote (-7.5%), trackside (-14.0%) and media (-1.1%), where growth was much lower than in 1Q due to increased competitor activity before the credit betting ban kicks in.

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



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