

Australian Equities High Conviction Portfolio

Performance Report – December 2021

Market overview and portfolio performance



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The S&P/ASX 200 Accumulation Index was up 2.75% during the period.

Utilities (+6.9%) was the best performing sector, as higher energy prices and the persistence of investor interest in utility and infrastructure assets saw the sector well supported. Materials (+6.4%) also outperformed as iron ore prices continue to recover in the face of increasing Chinese monetary stimulus. Information Technology (-5.4%) was the worst performing sector, largely on the back of poor returns from Afterpay (APT -23.7%) which reacted to a major sell down of potential parent company Block (NYSE:SQ). Consumer Staples (-2.4%) also underperformed with sector heavyweight Woolworths Group (WOW -6.9%) disappointing investors at its first half trading update.

DNR Capital Australian Equities High Conviction Portfolio underperformed the Index for the month. Key stock contributors were Afterpay (APT, No Holding), South32 (S32) and Woolworths Group (WOW, No Holding). Key stock detractors were Commonwealth Bank of Australia (CBA, No Holding), SEEK (SEK), and TPG Telecom (TPG).

Portfolio overview

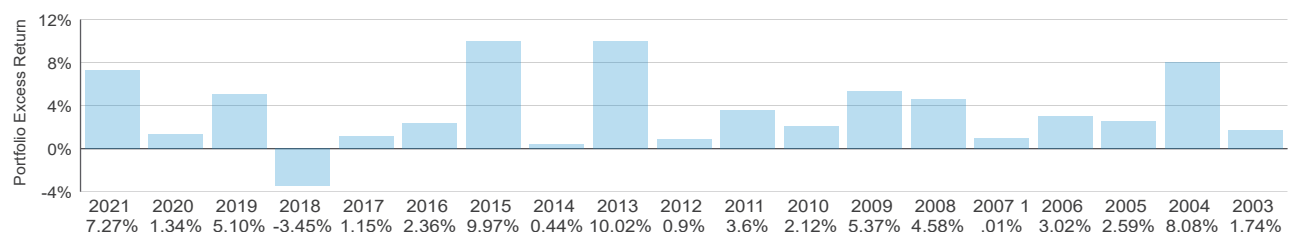
Investment bias	Style neutral
Designed for	Investors with a medium-term investment objective focused on achieving portfolio growth with less focus on generating excess income and is prepared to accept higher volatility in pursuit of higher growth
Benchmark	S&P/ASX 200 Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Accumulation Index by 4% p.a. (before fees) over a rolling three year period
Investable universe	ASX listed securities with a focus on the S&P/ASX 200
Number of stocks	15–30
Asset allocation	Australian equities 80–100% Cash 0–20%
Stock limit	15% maximum weighting
Minimum suggested investment timeframe	5 years

Gross active return

	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
High Conviction Portfolio	1.65	2.03	6.19	24.50	18.01	11.71	12.17	14.10	12.79
S&P/ASX 200 Accumulation Index	2.75	2.09	3.84	17.23	13.62	9.76	8.99	10.80	9.44
Excess Return	-1.10	-0.06	2.35	7.27	4.39	1.95	3.18	3.30	3.35

* Inception date—October 2002

Excess return (calendar year)



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.

Market review

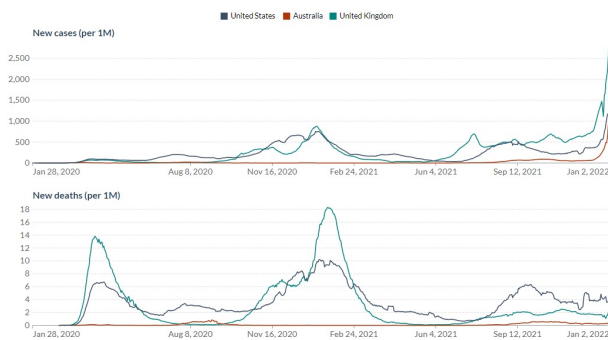
Summary

2021 saw the beginning of the end of COVID-19's grip of global markets but its legacy will echo for the foreseeable future. The Omicron variant has sparked further anxiety but appears to be ushering an acceptance of the virus's transition from pandemic to an inevitable part of everyday life. This month we review the current COVID-19 challenges in context of rapidly growing cases but tentative optimism on its severity. As we enter a transitional period of monetary policy normalisation and wind down of fiscal stimulus, we also take stock of the portfolio's hits and misses over the past twelve months and assess the emerging opportunities for investors in 2022.

COVID-19 update

The Omicron variant, combined with a sustained reopening, has seen asymptomatic growth in cases around the world. Global vaccination efforts may not be preventing breakthrough cases as the virus evolves, but the death and hospitalisation rates have to-date remained subdued.

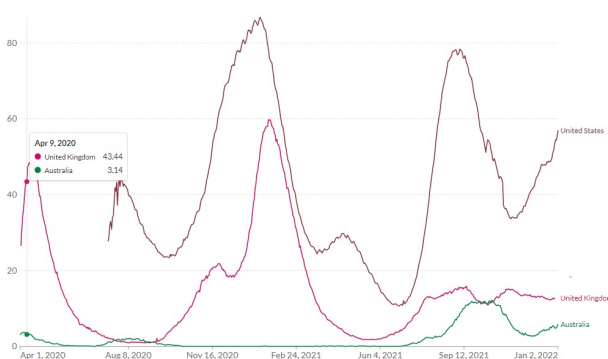
Daily new confirmed COVID-19 cases and deaths per million people



Source: John Hopkins University CSSE COVID-19 Data

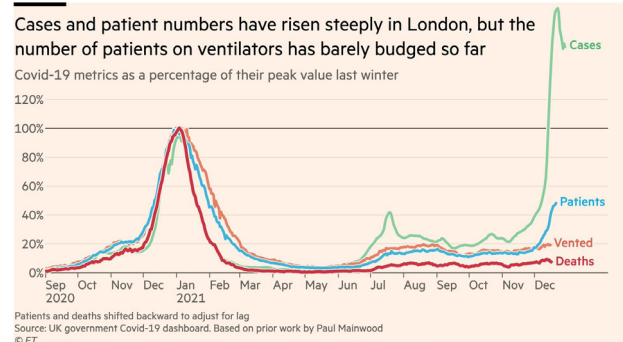
Whilst too early for experts to fully attribute this welcome development, it appears to be a result of a combination of high vaccination rates, improved treatment, and a potentially milder variant.

Number of COVID-19 patients in intensive care (ICU) per million people



Source: Official data collated by Our World in Data

As noted in the Financial Times, in January 2022, despite record cases, key severity indicators are encouragingly resistant.



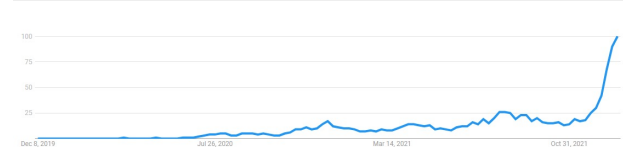
Source: UK government COVID-19 dashboard

Despite the encouraging data, health systems have limited resources and exposed workforces. As the total number of infections grows, a deterioration in the absolute number of critical care admissions will influence government responses.

Testing has become a bottleneck in the world's march towards normality, revealing another pressure point in a global supply chain already under duress. Testing resources have become critical to managing the reopening of economies. Issues with availability are well demonstrated in Australia, where backlogs are impacting movement and activity. Pent-up intentions to travel, unleashed over the holiday period, have been hampered as interstate and international requirements overwhelmed the available testing resources.

The familiar polymerase chain reaction (PCR) nasal swabs provide greater accuracy, with genetic detection able to identify very small amounts of viral DNA, but require a laboratory and several hours to produce results. Lateral flow or Rapid Antigen Tests (RAT) detect associated proteins with SARS-COVID-2 and can produce result in 15-30 minutes, but they carry a greater risk of incorrect results. Nonetheless, necessity has dictated a relaxing of testing pre-conditions. With the PCR testing beyond its capacity, RAT's are becoming the *de facto* solution, unfortunately coinciding with a global shortage of them.

Google search trends for rapid COVID-19 antigen test



Like vaccines before them, RAT production and distribution may take some time to ramp up but will ultimately end in an affordable glut.

Key 2022 opportunities and threats

Threats

The benchmark US 10-year bond yield resumed its upward trajectory, reflecting anxiety around inflation and the withdrawal of quantitative easing. With the market now fully pricing three rate rises in CY2022, risks are emerging over equity valuations, as the relative attractiveness of bonds increases. Whilst many unknowable variables influence this trend, pressure on growth and longer duration equities is likely to grow alongside a steepening yield curve. Despite a healthy consumer and robust earnings growth being observed in many sectors, the impact of rapidly rising interest rates could hamstring the global recovery and foreshadow a recession.

Supply chains continue to be impacted following waves of COVID-19 related restrictions and supply constraints, concurrent with record demand. The inability to secure inputs and inventory has the potential to derail many industries, further stoking inflation and impact margins.

The Chinese property market continues to be volatile with the People's Bank of China (PBOC) attempting to balance a crackdown on excessive speculation and leverage while not damaging this important component of the Chinese economy. Australia in particular remains heavily exposed to Chinese domestic production to support the housing market.

Opportunities

Volatility in equities has at times spiked during the year, but generally remained subdued. Whilst an obvious risk to equity markets, as active managers we are primed to take advantage of opportunities to buy durable, high quality franchises during periods of market dislocation.

Decarbonisation - following the COP26 UN Climate Change Conference (Glasgow), momentum continues to build for reducing carbon across the economy. Long-term opportunities exist for a range of companies exposed to this trend, requiring substantial levels of commodities, labour and capital to facilitate the goal.

Digitisation is a well-established thematic that is still evolving. Alongside the explosion in new technology businesses, traditional companies are seeking to reduce costs by investing in digitisation and automation. Successfully deploying technology solutions to replace manual operations both supports margins and provides competitive advantages. Investments in flexible and automated platforms can lead to market share gains while saving on staffing costs. Many companies are succeeding in porting their products and services online, leveraging existing IP from traditional use cases into new opportunities.

2021 Hits & Misses

As part of our investment process, as a team, we undergo a deep dive into our largest contributors and detractors from the portfolio to provide a fresh perspective and draw lessons from our research and positioning during the year.

Hits

Aristocrat Leisure (ALL) – ALL continued its strong record of execution, with market leading product for land-based casinos and a growing digital gaming market. ALL continues to invest heavily in its creative talent, consequently taking market share, and facilitating further investment for the future. The group enjoyed very strong profit growth in the year compared to the COVID-19 impacted prior period. Late in the year, the group launched a bid for Playtech, a strategy aimed at entering the large and growing US iGaming market. The bid has subsequently turned competitive, and whilst still well positioned to complete, we await the outcome of the process.

Domino's Pizza Enterprises (DMP) - Our position in DMP over the past two years has contributed meaningfully to Portfolio performance as the group's global network grew strongly while it benefited from COVID-19 lockdowns. Following a strong full year result, DMP's stock price increased nearly 30%, materially exceeding our assessed valuation and leading us to meaningfully reduce the portfolio's holdings. Given a subsequent downgrade to its Japanese operations, the lower active position aided performance. We remain attracted to DMP's long-term prospects and look for opportunities to increase our position again.

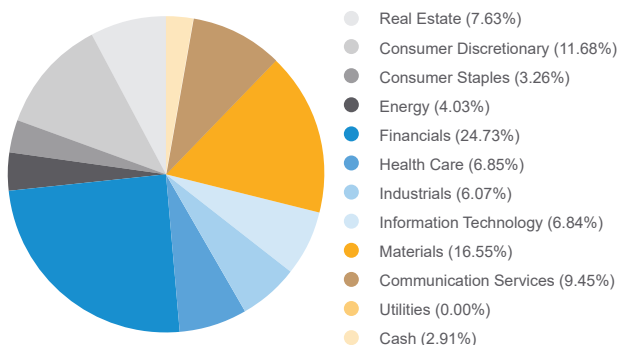
Misses

Lendlease (LLC) - Our overweight position in LLC detracted from performance as continued COVID-19 lockdowns weighed on the group's operations. LLC's operating businesses have been particularly susceptible to COVID-19 lockdowns, with tenants and investors reluctant to commit to large urban projects, given a heightened level of uncertainty. A new management team also adopted more conservative accounting assumptions, further impacting near term earnings. We believe the undemanding valuation already reflects weak expectations for nearer term earnings. LLC has a backlog of over \$110b in large urban regeneration projects, which while heavily impacted, are held in capital-light structures offering flexibility in terms of development timing. The business has been materially streamlined through COVID-19 and is well positioned for an earnings recovery as the impact of lockdowns ease.

Woodside Petroleum (WPL) - WPL was a key underperformer for the strategy, reflecting weakness in the Australian Energy sector more generally. The poor performance of the sector (-2.0%) represents a significant outlier given the performance of key drivers and comparators. During the year, the price of oil (West Texas Intermediate (WTI)) rose from USD 48.4 to USD 75.3 (+55.8%), the AUD fell from 0.77 to 0.73 (-5.2%) and the performance of the Energy sector in the US markets was 47.7%, the highest performing sector for the year - all pointing towards expected strong performance of the Australian majors. In addition, WPL has entered into an agreement to acquire the BHP Petroleum assets which will substantially increase asset quality and provide strong cash flows to fund future growth. This leads us to believe that there remains a significant mispricing opportunity in Australian energy names and WPL in particular.

Portfolio attribution

Sector weightings %



Source: DNR Capital

12 month - top contributors and detractors

Top 3 contributors		Alpha*
Afterpay	No Holding	0.35%
South32	Overweight	0.25%
Woolworths Group	No Holding	0.23%

Top 3 detractors		Alpha*
Commonwealth Bank of Australia	No Holding	-0.43%
SEEK	Overweight	-0.25%
TPG Telecom	Overweight	-0.16%

Monthly - top contributors and detractors

Top 3 contributors		Alpha*
Macquarie Group	Overweight	1.15%
Domino's Pizza Enterprises	Overweight	0.98%
South32	Overweight	0.93%

Top 3 detractors		Alpha*
Lendlease	Overweight	-1.39%
Commonwealth Bank of Australia	Underweight	-0.62%
Woodside Petroleum	Overweight	-0.55%

* 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 for the month were:

- **Afterpay** (APT, No Holding): underperformed in line with Nasdaq listed acquirer Block (formerly Square), as broader underperformance of technology stocks weighed on the stock.
- **South32** (S32): outperformed during the month as strong spot prices for the underlying commodity mix continued to drive earnings upgrades. S32 also made further progress on the Sierra Gorda copper transaction which provides it with more diversity across commodity type and increased exposure to forward facing commodities.
- **Woolworths Group** (WOW, No Holding): underperformed following a trading update and earnings guidance below market expectations. COVID-19 direct and indirect costs had accelerated while sales moderated during the period.

The top stock detractors for the month were:

- **Commonwealth Bank of Australia** (CBA, No Holding): the banks bounced back after a poor month in November on limited news.
- **SEEK** (SEK): underperformed in December on no stock-specific news. The tailwinds from economic recovery and a re-architecting of its pricing structure positioning it well in the medium to long term.
- **TPG Telecom** (TPG): founder and prior Chairman, David Teoh, sold ~3% of his stake in the company this month. The market treated this cautiously given he has ~15% remaining in escrow until mid-2022.

Portfolio positioning

We have positioned the Portfolio as follows:

- **Inflation hedges.** Exposure to a number of stocks that benefit from rising inflation such as Computershare (CPU) and QBE Insurance Group (QBE).
- **Defensives with bottom up drivers.** We have increased our exposure to defensives given the Chinese / stagflation risks.
- **Quality market leaders.** Quality stocks with pricing power can protect earnings during an inflationary period. Stocks such as SEEK (SEK), James Hardie Industries (JHX) and Xero (XRO) retain strong pricing power.
- **Opening up laggards.** While the cyclical recovery might slow if the supply chain constraints accelerate, the economies will continue to open which will present opportunities for those stocks which have been impacted by lockdowns.

Key risks

- **COVID-19 disruption.** The longer and deeper the disruption from the COVID-19 pandemic, the greater the negative impact on equity markets. Any disruption to the roll out of the vaccines would be negative, as would the development of vaccine-resistant COVID-19 variants.
- **Interest rates.** Low interest rates are the prime driver of markets at present. Any change to the inflation outlook would have a significant impact on valuations.
- **Political environment.** Further geopolitical uncertainty including civic destabilisation in the US and regional tensions with China could create negative implications for stocks and portfolios.
- **Global growth.** Higher energy costs and supply chain disruptions could drag on global growth rates.

Portfolio moves

No changes to the Portfolio.

Investment strategy

The Australian Equities High Conviction Portfolio has an investment style best described as 'style neutral'. The security selection process has a strong bottom-up discipline and focuses on buying quality businesses at reasonable prices. 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.

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.

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.

Platform access

- AMP PPS
- BT Panorama (Direct, Compact and Full)
- Colonial First State FirstWrap
- Federation Alliance
- HUB24
- Linear
- Macquarie Wrap
- Mason Stevens
- Netwealth
- OneVue
- Powerwrap
- Praemium
- Wealthtrac



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