

Australian Equities High Conviction Portfolio

Performance Report – April 2022

Market overview and portfolio performance



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The S&P/ASX 200 Accumulation Index was down 0.85% during the period.

Utilities (+9.3%) was the best performing sector, with key constituents APA (APA +7.7%), Origin Energy (ORG +9.8%) and AGL (AGL +12.4%) all stronger on the back of stronger energy markets and ongoing private equity interest. Industrials (+3.4%) also outperformed with reopening plays such as Transurban (TCL +5.8%) and Qantas (QAN +7.5%) benefitting from increased normalisation of travel. Information Technology (-10.4%) was the worst performing sector, with increasing bond yields and inflation prompting a large sell off in expensive technology names in the US. Consumer Discretionary (-3.2%) also underperformed, with an emphasis of selling in higher growth companies and those who have benefitted throughout the COVID-19 period, where revenues may have been pulled forward.

DNR Capital Australian Equities High Conviction Portfolio underperformed the Index for the month. Key stock contributors were Lendlease (LLC), QBE Insurance Group (QBE) and Block Inc (SQ2, No Holding). Key stock detractors were Aristocrat Leisure (ALL), Ramsay Health Care (RHC, No Holding) and Iress (IRE).

Portfolio overview

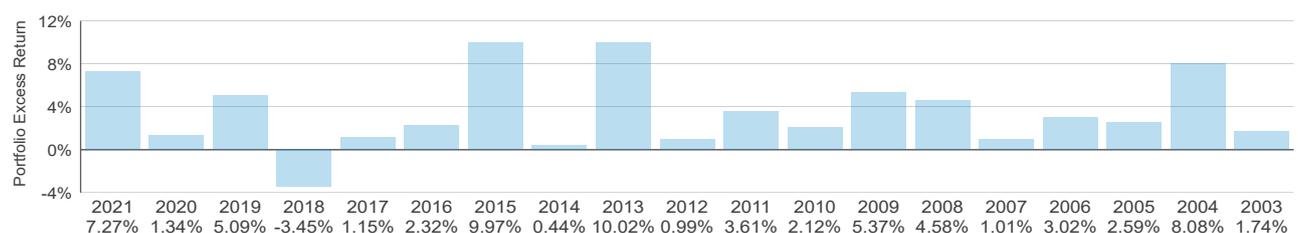
Investment bias	Style neutral
Designed for	Investors with a medium-term investment objective focused on achieving portfolio growth with less focus on generating excess income and is prepared to accept higher volatility in pursuit of higher growth
Benchmark	S&P/ASX 200 Accumulation Index
Investment objective	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	-0.92	9.77	7.29	17.58	14.58	11.52	11.31	13.38	12.86
S&P/ASX 200 Accumulation Index	-0.85	8.24	3.59	10.16	9.42	8.81	7.94	9.90	9.34
Excess Return	-0.07	1.53	3.70	7.42	5.16	2.71	3.37	3.48	3.52

* 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.

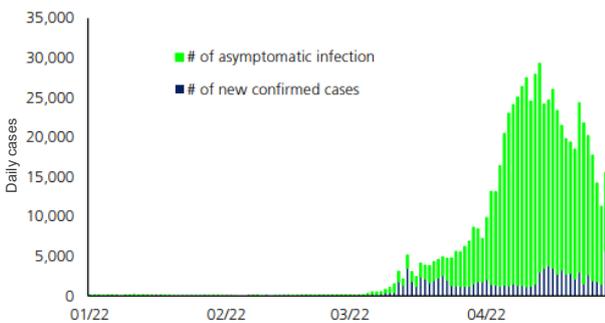
Market review

This month we focus on the lockdown in China and the likely stimulus plan which will be important for appetite for Australian commodities. In addition we note the deterioration in sentiment as expectations for interest rates rise and the impact this is having on growth stocks and the broader market.

China

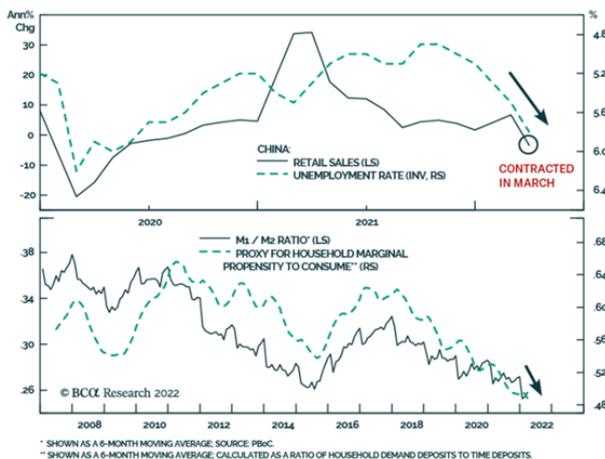
As has been well reported in the press, China has experienced an outbreak of COVID-19. While it appears to be peaking, China has taken harsh measures to lockdown the economy. Vaccination rates are not as high in China as many western countries and their vaccine has been less effective. This raises the question as to when they will return to normality. Whilst we do not have a definitive answer to this question, we would suspect that the pathway forward will not be dissimilar to the West, meaning weakness due to concerns regarding the lockdown will likely represent a buying opportunity.

Omicron appears to be peaking in China



Source: CEIC, UBS estimates

Complicating discussions regarding China is the fact its economy has been slowing for a while. The chart below highlights tightening liquidity has contributed to a reduction in the desire to consume which has fed into slowing retail sales and unemployment. China has been attempting to rebalance the economy away from speculative housing development but these attempts have begun to be a little too successful causing distress in property markets and a slowdown in gross domestic product (GDP).



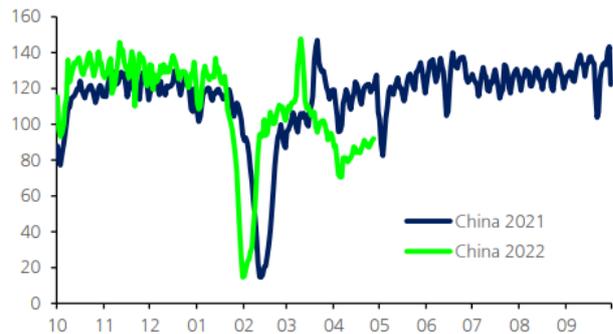
Source: BCA Research

There is an old saying 'start investing when the central banks start panicking'. Until recently the Chinese authorities have been careful regarding the level of

stimulus they have been prepared to throw at the economy due to fears of pumping up the speculative bubble in property once again. However the disruption caused by COVID-19 (the chart below highlights the disruption to logistics operations caused by COVID-19) appears to have tipped their hand.

Logistics disruptions

Full truck load traffic index



Source: Wind, UBS estimates

Comments from the Chinese Politburo, led by President Xi Jinping signalled a change in policy priorities. "Covid must be contained and the economy must be stabilized" and "We should waste no time in planning more policy tools and enhance the strength of adjustment in due course." Authorities should "strive to achieve full year economic and social development goals" the Politburo said. Leaders also vowed to guarantee "supply chains in key sectors" and smooth transport logistics, as they pledged to "positively respond" to demands from foreign-invested companies for a smoother business operating environment. The Politburo pledged to "strengthen infrastructure construction in an all-around way" and to support the housing market. While officials repeated the phrase that "houses are for living in not for speculation", the government said it would also work to meet the demand for better quality housing and "optimize" the supervision on developers' income from project pre-sales.

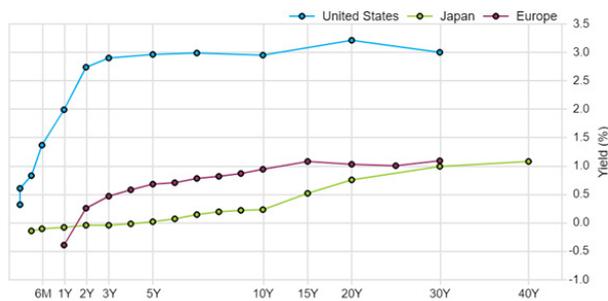
Although detail was provided here, it is worth remembering that the Politburo's meetings usually set the tone for official policy and highlight any major adjustments, which are then followed up with specific steps outlined by various government agencies. While China runs risks around inflation, they appear to be more concerned with the slowdown they have been experiencing and are inclined to stimulate. This should be supportive for commodity demand.

Interest rates and stagflation

Interest rates

Interest rate expectations have continued to rise following a series of strong inflation numbers across the globe. Australian 2 year bonds are now 2.4% and the US is close to 3%. Australia has much higher consumer debt than the US and interest rates have a more direct impact on the consumer via mortgages (which are largely variable or short term fixed in Australia). Mortgages in the US are fixed for 30 years and gearing levels are much lower so we suspect the US will need to maintain higher interest rates relative to Australia to suppress demand and allow inflation to normalise.

Treasury bond yields in various markets



Source: FactSet

We note inflation is being driven by a range of factors including COVID-19 disruption to supply, de-globalisation as countries seek to secure supply of commodities and supply chains, and fiscal stimulus. While fiscal stimulus will ease from the COVID-19 highs, we note globally the response to higher prices has been further fiscal initiatives (reduction of fuel excise, home equity assistance, student debt forgiveness etc.). Monetary policy will need to do the heavy lifting to offset the government's desire to appear to be supporting the population during a difficult period.

The result of the higher interest rates has been a fall in growth stocks as noted in the Nasdaq below and rising concerns regarding the risk of recession. Ultimately the goal of higher interest rates is to slow the economy. It would be unusual for the US to move into recession so quickly after the first rate rise, however a slowdown in the economy should be expected.

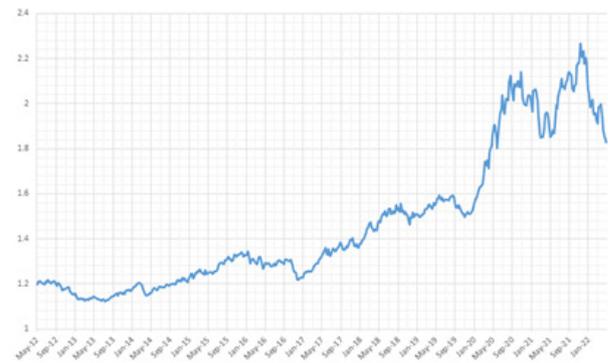
Nasdaq



Source: FactSet

Growth stocks have fallen sharply in response to the higher rates and sentiment has turned negative which is usually a contrary indicator. Furthermore we do not anticipate a recession in the near term and we think the markets could rally post an interest rate rise (with the world unlikely to fall apart). So this raises the possibility that the growth stocks could become oversold setting up a buying opportunity. However growth stocks have enjoyed a strong run over the past decade and have been trading on high multiples for some time.

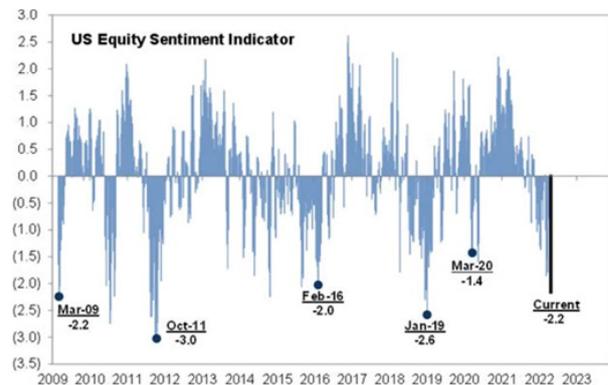
S&P growth / S&P 500 value



Source: Iress

Earnings in many names were also inflated during COVID-19 (for example shopping online was elevated and is now normalising). As growth stocks underperform there is a risk that growth funds lose money causing forced selling and further underperformance. At the same time the environment has improved for sectors that have been out of favour for some time (resources, industrials and energy). Nonetheless we will always be on the lookout for high quality businesses trading cheaply and a sell off could present a range of opportunities. The sentiment indicator below highlights the sharp move negative which often is a contrary short term indicator.

US equity sentiment indicator



Source: Goldman Sachs

Summary

Key negatives:

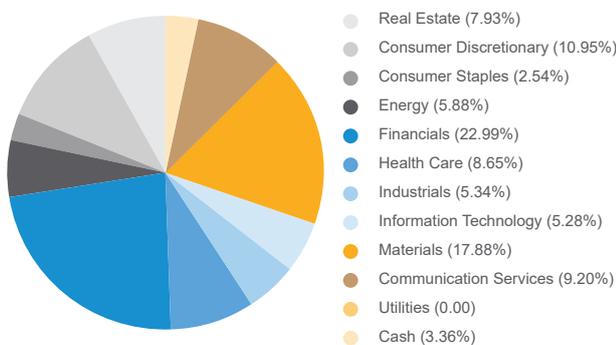
1. Rising interest rates mean the market does not have a backstop of the US Federal Reserve (Fed) coming in to support, leaving it more vulnerable to a period of volatility.
2. Complacency regarding inflation which looks much stickier and is not simply about COVID-19 disruption. Fundamental political change to the appetite for fiscal stimulus and a move away from globalisation means inflation is likely to be here for longer. This means higher interest rates for longer.
3. Ultimately a rate cycle ends with a slowing economy, which is in front of us now. The question is how long does this take to play out and can the Fed engineer a soft landing. We believe more defensive positioning is needed as a result.

Key positives:

1. Australia is better placed than other countries and unlikely to see the same level of interest rate rises.
2. China is moving to stimulate their economy which further supports Australia.
3. Market fears regarding interest rates are pronounced and sentiment has turned sharply negative. There is potential for a 'buy the fact' rally post a more substantial rate rise. The extent of the rally will depend on the extent that near term recession risk eases.

Portfolio attribution

Sector weightings



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors		Alpha*
Lendlease	Overweight	0.38%
QBE Insurance Group	Overweight	0.24%
Block Inc	No Holding	0.17%
Top 3 detractors		Alpha*
Aristocrat Leisure	Overweight	-0.22%
Ramsay Health Care	No Holding	-0.14%
Iress	Overweight	-0.13%

12 month - top contributors and detractors

Top 3 contributors		Alpha*
Computershare	Overweight	1.85%
South32	Overweight	1.32%
Woodside Petroleum	Overweight	1.28%
Top 3 detractors		Alpha*
Commonwealth Bank of Australia	Underweight	-0.69%
Aristocrat Leisure	Overweight	-0.58%
SKYCITY Entertainment Group	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:

- **Lendlease (LLC):** rallied during the month after a period of underperformance. Management continues to make incremental progress towards their stated 2024 return targets with a sharpened focus on executing the existing development backlog of over \$100bn.
- **QBE Insurance Group (QBE):** higher bond rates are boosting earnings. Furthermore offshore competitors announced solid results.
- **Block Inc (SQ2, No Holding):** Square underperformed during the period in line with the broader global technology sector, with rising bond yields disproportionately impacting higher growth companies with limited profitability.

The top stock detractors for the month were:

- **Aristocrat Leisure (ALL):** a slowdown in growth in its online games (possibly disrupted by the Ukraine War) impacted the stock. This appears to be captured in valuations.
- **Ramsay Health Care (RHC, No Holding):** rallied on a takeover bid from KKR & Co. We think the bid fully values the business and only see a slight chance of a counter bid emerging.
- **Iress (IRE):** despite being cheaper than peers it appears to be caught up in the global sell down on tech stocks.

Portfolio positioning

Focused on identifying strong bottom-up investment opportunities in an environment of higher inflation, higher bond yields and an ongoing recovery from COVID-19:

- Positive on **diversified quality mining** companies generating strong cash flows.
- Positive on **high quality industry leaders** with strong pricing power to offset inflation.
- Adding to **domestic defensive exposures** given relative outlook for domestic economy.
- **Overweight financials with leverage to higher rates** but underweight banks (given they have recession risk).
- **Disciplined on valuations**, especially longer duration stocks where valuations are highly sensitive to interest rates changes.
- **Cautious on low quality/negative cash flow** companies where higher interest rates will expose excessive risk taking.
- **Cautious on** companies that have experienced significant over consumption during COVID-19.
- **Positive on** companies that have been under-earning due to COVID-19 restrictions.

Key risks

Key risks to the Portfolio include:

- **Political environment.** The crisis in Ukraine and sanctions against Russia are severely impacting commodities markets, with the potential to destabilise the region and cause global inflationary shocks. Regional tensions with China also continue to pose risks to trade.
- **COVID-19 disruption.** The development of vaccine-resistant COVID-19 variants or sustained supply chain impacts still poses risks, especially with government support mostly withdrawn.
- **Interest rates.** Low interest rates have been a primary driver of markets over the past few years. With markets now pricing monetary tightening, changes to this trajectory or further inflationary shocks would have a significant impact on valuations.
- **Global growth.** Sanctions against Russia are driving up energy prices and creating global energy security concerns. Historically, sustained price shocks in oil have impacted global growth and catalysed recessions.

Portfolio moves

Purchase of Worley (WOR)

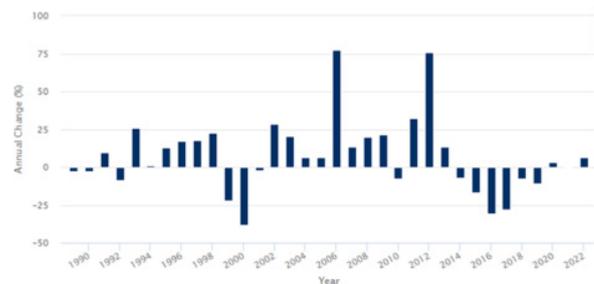
WOR is a market leading engineer that consults across a range of complex areas within resources, chemicals and energy. It is exposed to the spending required to transition the world to net zero carbon and to the spending required to ensure security of supply of energy post the Ukraine war.

WOR is relatively well placed from a quality perspective compared to other players in the resources / energy sectors.

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

1. **Industry structure:** WOR is a market leader with a strong brand and reputation. WOR will be among a small group of engineers invited to tender on complex work and the industry structure looks much improved following years of underinvestment in capex as well as a need to invest for the transition for net zero carbon.

Actual capital expenditure on Mining (annual change)



Source: IBES estimates

2. **Earnings strength:** Returns and margin are low at this point in the cycle, however given the strong demand that is necessary for the energy transition we expect significant improvement in coming years. We have already seen capex intentions from major oil and gas companies increase 25% this year as a sign of a bottom and we have seen job advertisements for engineers improve.
3. **Balance sheet:** WOR is a low capital intensive business that supports the current capital structure. Interest cover of 10x at the bottom of the earnings suggests the balance sheet is in good shape.
4. **Management:** Deserves credit for repositioning the company (ahead of peers) to take advantage of the transition to net zero carbon.
5. **Environmental, social and governance (ESG):** WOR will be one of the important companies on the ASX to assist in the complex engineering necessary to transition the world to net zero carbon.

Conclusion

WOR is a highly cyclical stock which means some of the quality characteristics are less obvious at this point of the cycle. However we think it compares favourably to the companies directly exposed to commodities and the broader industry backdrop looks much improved. A range of lead indicators look promising – capex budgets of customers are up, job advertisements and staff numbers are rising. There has been a massive underinvestment for years and very strong demand. This is a heady mix that should ensure improved earnings which are not yet captured by market forecasts.

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.

Disclaimer

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