Australian Equities Socially Responsible Portfolio

Performance Report – October 2020

Market overview and portfolio performance

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The DNR Capital Australian Equities Socially Responsible Portfolio underperformed its benchmark for the month. Key stock contributors were Virgin Money UK (VUK), Lendlease (LLC) and REA Group (REA). Key stock detractors were Corporate Travel Management (CTD), Commonwealth Bank of Australia (CBA, no holding) and IPH (IPH).

The S&P/ASX 200 Accumulation Index was up 1.93% during the period. Information Technology (+9.0%) was the best performing sector during the month as Link Administrative Holdings (LNK) +27.9% was the subject of a private equity bid and Afterpay (APT) +21.0% continued its strong run. Financials (6.3%) also outperformed the broader market, with banks and fund managers benefiting from a targeted value rally, typified by Virgin Money UK (VUK) +26.9% and Pendal Group (PDL) +18.5%. Industrials (-3.9%) was the worst performing sector with major names like Aurizon Holdings (AZJ) -12.6% and Brambles (BXB) -8.8% struggling to attract investors ahead of key quarterly updates. Utilities (-1.5%) also performed poorly, with energy assets in particular suffering from the uncertainty surrounding the impact of a widespread renewables push. AGL Energy (AGL) -8.4% and Spark Infrastructure (SKI) -3.2% were the key detractors.

Portfolio overview

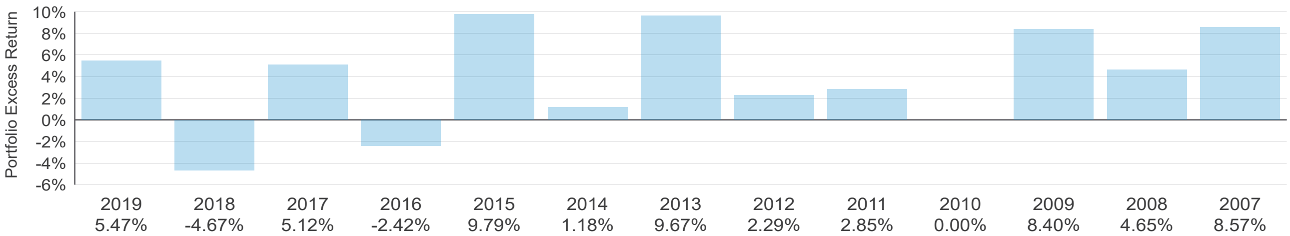
Investment bias	Style neutral
Designed for	Investors who want a competitive return but do not want investments judged to have involvement in gaming, pornography, armaments and tobacco
Benchmark	S&P/ASX 200 Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Accumulation Index by 4% 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
Certifications	Certified by RIAA (Responsible Investment Association Australasia)—Responsible Investment Certification Program

Gross active return

	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Socially Responsible Portfolio	0.61	0.77	8.53	-8.32	3.69	6.97	7.23	9.80	9.08
S&P/ASX 200 Accumulation Index	1.93	0.98	8.67	-8.15	4.09	6.80	5.63	6.94	5.66
Excess Return	**-1.32**	**-0.21**	**-0.14**	**-0.17**	**-0.40**	**0.17**	**1.60**	**2.86**	**3.42**

** Inception date—June 2006*

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

Over the past month uncertainty regarding the outcome of the US election and rising COVID-19 case numbers have overhung the market. This uncertainty has seen further support for growth stocks. This month we highlight the outcome from the US election and further delve into the debate between growth and value. Of interest in this regard is a number of takeovers that have begun as cheap stocks, combined with cheap money, prove too tempting for private equity.

US election

Saving legal challenges, it appears we have a Biden Presidency combined with a Republican Senate. There was no 'blue wave' and no Trump victory. We think this was the best possible outcome for markets. Markets like certainty. A Trump victory promised lower taxes and less regulation, but with more geopolitical uncertainty and a lack of trust in global institutions. A 'blue wave' ran the risk of the left of the Democrats pushing a more aggressive policy agenda, which would have been destabilising for business.

We believe the election outcome is a victory for the centre. The Senate and the Presidency will need to work together to ensure an adequate stimulus package and the resulting compromises should add balance to the political process. However, some risk remains that the extremes will continue to exert undue influence on the political environment. It is likely the extreme left is going to continue to press its agenda and Biden's ability to hold the line will be tested. If he doesn't, he will risk the midterm Congressional election. Likewise, Trump is not likely to go quietly and will continue to cast a shadow over the Republicans and their agenda. The ability for the centre (which the public appears to favour) to enjoy clear air will remain a challenge.

In the days leading up to the result the market had begun to favour value stocks. The narrative being that a 'blue wave' would result in a large stimulus package boosting cyclical growth and thereby favouring cheaper stocks tied to the success of the broader economy. As the result unfolded, the market began to rotate back to growth stocks. The idea being that a large stimulus package is unlikely and therefore growth will remain elusive and bond yields low. With little being able to be done at a political level, there is then little reason to expect a rotation in leadership across the market.

As we have noted in recent months, we see the market as balanced between a range of factors:

1. A successful vaccine, versus further lockdowns.
2. Cheap cyclical value stocks, versus expensive growth stocks with greater certainty.
3. Further stimulus and substantial liquidity, meaning investors lack reasonable alternatives for their investments.

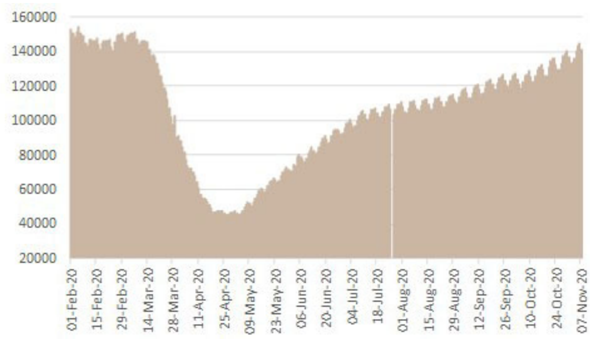
We await with interest the outcome of a successful vaccine development. The more successful the vaccine, the more quickly economies can reopen. Governments appear to be all in on a successful outcome.

Economic progress

While we await the development of a vaccine, there is no doubt Australia is better placed than many nations to ensure our domestic economy returns to a reasonable level of functionality. Over the past month we have seen bank deposits continue to grow rapidly (+$16b) as households increase their savings. The strong increase in the savings rate will provide a strong boost to the economy as it reopens. This, combined with cheap borrowing costs, is fuelling demand for housing, cars and other consumer goods. Of course this has come at the expense of overseas travel and other forms of social entertainment, which are down significantly. If we exclude Victoria, job advertisements have bounced strongly (in most states ahead of pre-COVID-19 levels) and likewise, retail sales are up. The successful development of a vaccine will allow the economy to reopen with confidence, then the low rates combined with high savings can accelerate a rotation into cyclical components of the market. This scenario is highly dependent on the vaccine.

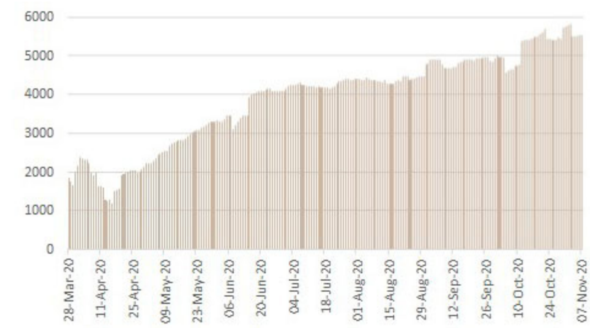
Surprising recovery in job advertisements

SEEK job listings daily



Source: MST tracker

SEEK new jobs posted per day (7 day rolling average)



Source: MST tracker

Growth versus value

Since the advent of securities analysis, the growth versus value debate has been a fixture in financial markets. Today, as with previous periods of extreme valuation, the great style debate polarises market participants and populates columns of financial press. Growth stocks have outperformed value counterparts to unprecedented levels since the GFC. The history of the stock market however, is punctuated with periods where both styles have been in and out of favour. There are several categories of both value and growth investing, with different opportunities and risk profiles, and in assessing portfolio exposure, it is important to understand these nuances. We review the rationale behind each strategy and analyse the key drivers to put the current situation into perspective. In informing DNR Capital's investment strategy, this debate is a constructive lens through which to assess the broader market, but quality remains the core of our philosophy. We explore how a balanced approach to selecting the highest quality stocks delivers sustainable performance, without anchoring portfolios to a blind commitment to one style.

What is growth and value?

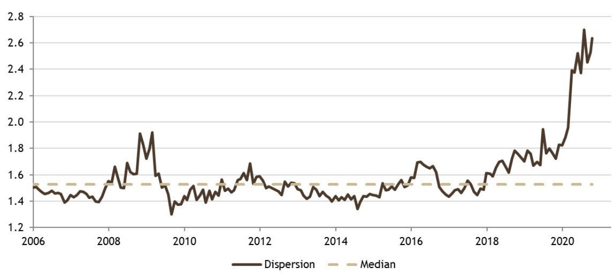
In analysing this concept, it is important to understand the characteristics of each category. There is no consensus on what defines value or growth, but a range of generally accepted metrics are applied by analysts, asset allocators and index providers. In its simplest form, a security trading at a discount to its underlying worth today, is regarded as value. Growth stocks offer earnings (or revenue) profiles growing materially above GDP, and generally trade on higher multiples than value peers. Numerous academic papers explore this topic, but the size of discount or required level of growth is highly subjective. To complicate the matter, there are scenarios where growth stocks can be cheap, value stocks can offer significant earnings upside, and many stocks won't meet either criteria.

Value investing

An assessment of fundamental value can be highly subjective, and we regard a purely quantitative approach to be a blunt instrument. For example, varying industries attract higher or lower multiples based on characteristics like defensiveness, addressable market and return on capital. A stock may be cheap relative to its industry peers, but expensive against the market.

One way to evaluate the outperformance of growth is through the price to earnings (PE) multiple dispersion. This measures the difference between stocks with high expected growth versus low growth stocks.

Price to earnings multiple dispersion



Source: UBS Quant and Strategy

Having achieved record highs not seen since the tech bubble, and sitting well above GFC levels, this indicator is several standard deviations above the mean. Historically, this dispersion has mean reverted, leading to value outperforming.

Growth investing

Growth stocks offer revenue or earnings growth materially above GDP, with opportunities to deploy capital into projects or products that will generate greater value in the future. The same reinvestment that generates future growth, reduces the earnings and cash flows that could be returned to shareholders nearer term. Paying for this future growth today generally results in higher near-term valuation multiples.

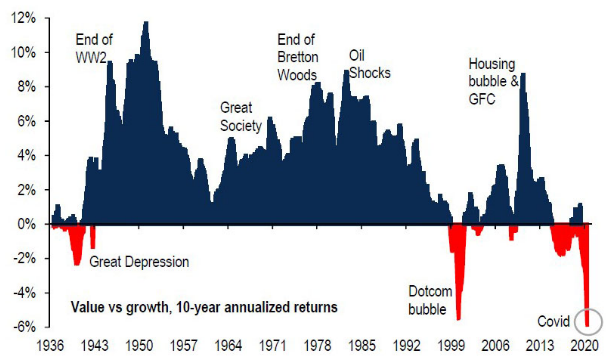
Arguments for growth investing

Growth investors believe that outperformance can be achieved by owning portfolios of stocks with above-average growth profiles and are willing to pay higher multiples for them. The current economic environment has produced a range of conditions supporting this style contributing to outperformance including lower interest rates, scarcity of growth and speed of disruption.

Where are we now?

Based on the metrics described above, there are few periods in history where the performance of these two styles has been more extreme. Overlaying the key market events of the past century puts the COVID-19 crisis into perspective, highlighting the historical significance of this recent period.

The worst ever returns to value stocks



Source: BofA Research Investment Committee, Fama & French.

Have we been here before?

When comparing the current environment to history, many investors recall the dot-com bubble of the late 90s. This period of irrational exuberance over new internet-enabled business models, yielded impossibly high valuations. Manic speculation saw businesses with little revenues, let alone earnings, drive an asset bubble that crashed spectacularly in late 2000. A similar bifurcation of value and growth was observed, and aligned with a period of easy monetary policy. The current environment is manifestly different however, and in contrast to the names that caused the tech-wreck, today's dominant technology growth stocks are highly profitable.

A more relevant timeframe to explore is the Nifty Fifty era of the late 1960s to early 1970s. This grouping of stocks represented the blue-chip growth darlings from a range of industries. A selection of these are still dominant today, with Walmart, Disney and Coca-Cola Amatil having evolved and prospered. Others, including Xerox, Kodak, IBM and Polaroid, constitute the who's who of yesteryear's cutting-edge technology names. Prior to the inflation shock of the 1970s, these portfolio stalwarts were bid up through a buy-and-hold mentality, trading at multiples well in excess of the broader market. This basket suffered enormously following the oil crisis of 1974, with subsequent inflation and interest rate spikes triggering falls in excess of 80%. Many of the Nifty Fifty no longer exist or have de-rated into low-growth industrials.

Time period comparisons

	Size		Valuation
	Market weight	Market Cap ($ Bn)	P/E (FY2)
FAAMG			
Apple	7.6%	2247	34.0
Amazon	5.1%	1504	80.4
Microsoft	5.9%	1753	31.6
Alphabet	3.6%	1058	30.5
Facebook	2.3%	691	29.9
FAAMG Aggregate	**24.5%**	**7253**	**31.6**
Tech Bubble			
Microsoft	4.5%	581	55.1
Cisco Systems	4.2%	543	116.8
Intel	3.6%	465	39.3
Oracle	1.9%	245	103.6
Lucent	1.6%	206	35.9
Tech Bubble Aggregate	**15.8%**	**2040**	**55.1**
Nifty 50			
IBM	7.1%	48	35.5
Eastman Kodak	3.6%	24	43.5
Sears Roebuck	2.7%	18	29.2
General Electric	2.0%	13	23.4
Xerox	1.8%	12	45.8
Nifty 50 Aggregated	**17.1%**	**116**	**35.5**

Source: Datastream, I/B/E/S, Worldscope, Goldman Sachs Investment Research

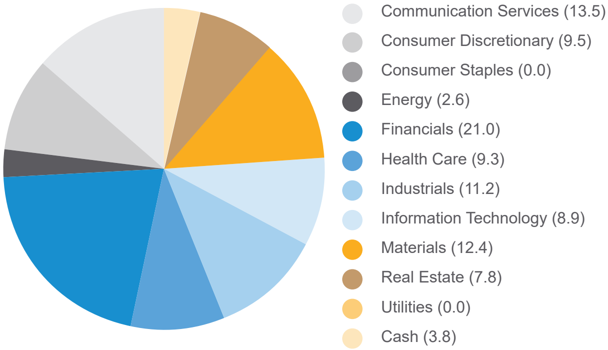
Both periods coincide with low inflation expectations and interest rates, factors we believe are contributing to the outperformance of growth today.

What does this mean for investors?

From an investor and asset allocator perspective, the current environment poses a conundrum. In general, value-focused investment funds have materially underperformed for over a decade. With valuation metrics stretched, positioning for a mean reversion makes intuitive sense. This strategy has had several false starts in the past 10 years however, and we believe is reliant on macroeconomic outcomes, especially a successful vaccine. Conversely, given the market's high PE multiple dispersion, we feel focusing too heavily on growth exposes portfolios to potentially savage de-ratings. Our process is about finding quality companies which we see as mispriced. Opportunities to buy strong franchises at reasonable valuation exist, but we are avoiding sectors of the market where transient themes and temporary trends have led to irrationality. Valuation discipline must remain a key component of stock selection, particularly with managing risk and sizing exposures.

Portfolio attribution

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors		**Alpha***
Virgin Money UK	Overweight	0.30%
Lendlease	Overweight	0.25%
REA Group	Overweight	0.20%

Top 3 detractors		
Corporate Travel Management	Overweight	-0.51%
Commonwealth Bank of Australia	No Holding	-0.44%
IPH	Overweight	-0.32%

12 month - top contributors and detractors

Top 3 contributors		**Alpha***
Breville Group	Overweight	2.44%
Resmed	Overweight	0.96%
REA Group	Overweight	0.96%

Top 3 detractors		
Lendlease	Overweight	-1.60%
CSL	No Holding	-1.39%
Fortescue Metals Group	No Holding	-1.18%

** 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:

- **Virgin Money UK (VUK):** Outperformed over the month as the strong increase in mortgage volumes due to stamp duty changes means UK banks have lifted pricing and this has improved sentiment to this deeply discounted sector.
- **Lendlease (LLC):** Rallied over the month following a period of underperformance. LLC continues to make progress exiting the troubled engineering business with the company reaching a non-binding agreement with the Victorian Government regarding the Melbourne Metro project.
- **REA Group (REA):** Outperformed as further easing of social restrictions improved auction clearance rates. The group also acquired a further stake in Indian based digital real estate business Elena. Given realestate.com.au's dominant market position, flexible cost base and strong balance sheet, we believe the group is well positioned for continued improvement in the housing market.

The top stock detractors for the month were:

- **Corporate Travel Management (CTD):** Underperformed during the month following a trading update at the AGM. Trends appear to be stabilising but not improving materially, causing concern that the recovery will be longer dated. Having recently completed its acquisition of North American corporate travel business Travel and Transport, we believe CTD is well position for a recovery in global business-related travel and accommodation.
- **Commonwealth Bank of Australia (CBA, no holding):** Banks outperformed over the month as expectations of a softer landing for the Australian economy, as well as stimulus initiatives, have reduced the depth of the bad-debt cycle in the short term.
- **IPH (IPH):** Underperformed during the period on no news flow. Some concerns exist around the potential impact of the COVID-19 downturn on patent filings, given that they are closely aligned with economic growth. However even considering an impact akin to the GFC, the share price remains well below fundamental valuations. A potential acquisition in a key target market would likely be a catalyst for repricing.

Portfolio positioning

Our current positioning is as follows:

- **Strong global franchise stocks:** Macquarie Group (MQG), SEEK (SEK), Cochlear (COH).
- **Strong domestic franchise stocks:** REA Group (REA), Ramsay Health Care (RHC), and Wesfarmers (WES).
- **Quality mid-caps:** Cleanaway Waste Management (CWY), ALS (ALQ), Xero (XRO), and Breville Group (BRG).
- **Reopen beneficiaries:** Scentre (SCG), IDP Education (IEL) and Corporate Travel Management (CTD).
- **Underweight banks.**

Key risks

Key risks to the Portfolio include:

- **COVID-19 disruption.** The longer and deeper the disruption from the COVID-19 pandemic, the greater the negative impact on equity markets.
- **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.
- **Inflation.** Given valuations have been supported by low interest rates, the emergence of inflation and higher bond yields could be a negative for markets.
- **Political environment.** It is an election year in the US, which adds to potential uncertainty. Legal challenges could create uncertainty. Further geopolitical uncertainty could create negative implications for stocks and portfolios such as the Chinese asserting their political power.

Portfolio moves

No Portfolio moves to report for October.

Investment strategy

The Australian Equities Socially Responsible Portfolio has an investment style best described as 'style neutral', focusing on environmental, social and governance (ESG) issues.

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 ESG risk.

The Australian Equities Socially Responsible Portfolio incorporates a negative portfolio screen across:

- pornography
- gaming
- armaments
- tobacco.

A positive ESG screen is also used to identify those securities with enhanced ESG policies.

DNR Capital sources ESG-related information from Bloomberg.

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.

CERTIFIED BY RIAA

The DNR Capital Australian Equities Socially Responsible Portfolio has been certified by RIAA according to the strict operational and disclosure practices required under the Responsible Investment Certification Program. See www.responsibleinvestment.org for details.[1]

1. The Responsible Investment Certification Program does not constitute financial product advice. Neither the Certification Symbol nor RIAA recommends to any person that any financial product is a suitable investment or that returns are guaranteed. Appropriate professional advice should be sought prior to making an investment decision. RIAA does not hold an Australian Financial Services Licence.

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