

# Australian Equities Socially Responsible Portfolio

## Performance Report – January 2020

### Market overview and portfolio performance



**Jamie Nicol**  
Chief Investment Officer



**Scott Bender**  
Portfolio Manager

The DNR Capital Australian Equities Socially Responsible Investment Portfolio underperformed its benchmark for the period. Key stock contributors were ResMed (RMD), Link Administration Holdings (LNK) and IPH (IPH). Key stock detractors were Corporate Travel Management (CTD), CSL (CSL, no holding) and Woolworths Group (WOW, no holding).

The S&P/ASX 200 Accumulation Index was up 4.98% during the period. Health Care (+12.0%) was the dominant sector as a plethora of names were up double digits, including large caps CSL (CSL +13.2%) and ResMed (RMD +14.4%). Information Technology (+11.1%) was also very strong as Afterpay (APT +31.7%) went on a run and Link Administration Holdings (LNK +18.1%) made an accretive acquisition. The outsized moves have largely been attributed to the continuation of the trend that we saw for the majority of last year; companies that exhibit defensive earnings or high growth outperforming against value and cyclical. The trade somewhat reversed in the latter stages of 2019 as bond yields ticked up, but Coronavirus fears and average economic data has pushed yields back down as we enter 2020.

### Portfolio overview

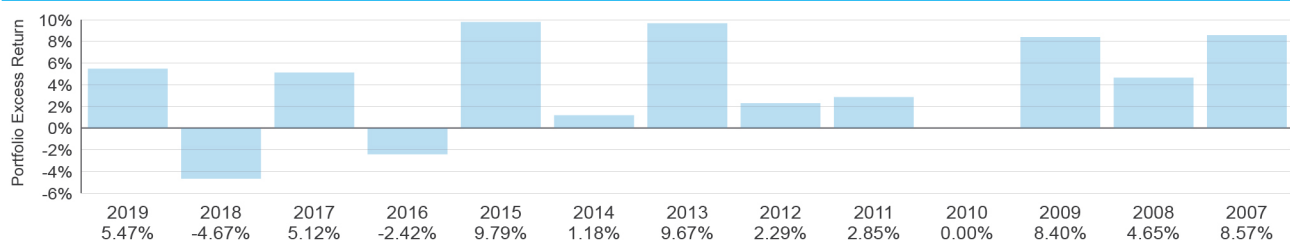
Investment bias	Style neutral
Designed for	Investors who want a competitive return but do not want investments judged to have involvement in gaming, pornography, armaments and tobacco
Benchmark	S&P/ASX 200 Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Accumulation Index by 4% 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	3.98	7.16	7.21	29.67	14.34	11.57	12.78	11.76	10.86
S&P/ASX 200 Accumulation Index	4.98	6.08	5.11	24.72	12.36	9.33	10.02	9.08	7.10
<b>Excess Return</b>	<b>-1.00</b>	<b>1.08</b>	<b>2.10</b>	<b>4.95</b>	<b>1.98</b>	<b>2.24</b>	<b>2.76</b>	<b>2.68</b>	<b>3.76</b>

\* 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.

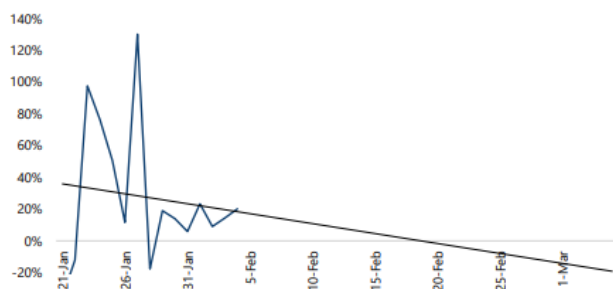
## Market review

January started with a bang and ended with a whimper (or a cough) thanks to Coronavirus. This month we assess the impact of the virus and the major issues impacting the positioning of the portfolio.

### Coronavirus

Following a very strong start to the year for the markets, the latest virus outbreak has triggered some selling and a further rotation into defensive growth names. Given the uncertain nature of the outcome of a global virus, it can attract concerning headlines. We provide some analysis of the potential impact below:

- Historically we have a precedent with the SARS outbreak, which killed 774 people and which had a mortality rate of 9.6%. At this point, Coronavirus has had a mortality rate of 2%. However, it is still in its early stages. There have been circa 43,000 confirmed cases worldwide.  
*Source: World Health Organization, 11 February 2020*
- During the SARS outbreak, the Chinese government was secretive and tried to hide the fact until it was too late. This time they have been more transparent and taken aggressive actions to contain the virus, including locking down a city with 11m people.
- Historically stocks and economies recover quite quickly from these types of events. From an economic perspective, SARS took around 1% off Chinese economic growth in 2003 but had no lasting impact on the economy. This time we expect a greater global impact, given the relative importance of the Chinese economy and the faster action taken to contain the virus. For stocks exposed to tourism and China, there can be a short-term hit to profits but we would not expect it to be long lasting (and therefore not impact the long-term cash flows from which we value businesses).
- From a trading perspective the markets have enjoyed the strong start to the year, and therefore can be vulnerable to a pick-up in volatility. We would expect concerns regarding the virus to remain at the forefront of markets until signs that the growth rate has peaked. We will be looking for good-quality businesses which become oversold during this period. The chart below highlights new cases. There is some suggestion of a slow-down in the rate of change but it remains at an early stage of uncertainty.



*Source: National Health Commission of the PRC, The Lancet. Note: The trend line shown is based on the first 15 data points and thus is subject to early volatility. It will become a better predictor as we move towards 30 data points.*

### Are defensive companies too expensive?

The impact of the virus is a further move by investors into defensive companies. Defensive growth names such as Woolworths and CSL have performed exceptionally well. Investors are being squeezed into equities via very low interest rates. Yet uncertainty due to low global growth, the virus and the political environment means investors are chasing a limited number of high-profile names. In some cases, this is causing extreme positioning. We display some examples of the various valuations in a number of sectors below. It is not so simple as to sell the expensive names and buy the cheap names. In many instances, stocks are either cheap or expensive for a reason. However, this can present stock-picking opportunities.

An example of such an opportunity is currently in the banks. Commonwealth Bank of Australia is the market leader with a strong franchise and good IT. It deserves a premium. Investors are favouring it, given there is no change in leadership at present and a potential buy-back. However, it faces many of the same risks as the other banks—low interest rates and limited credit growth, meaning earnings growth is difficult; greater regulatory scrutiny and greater competition are significant headwinds. Alternatively, Virgin Money UK has been at the epicentre of uncertainty thanks to Brexit and, as a consequence, it is trading cheaply yet offering better growth than the major banks, with a cost out program and an opportunity as a challenger bank to win share. We are seeking to exploit these types of opportunities.

Industry	Price/ Earnings Multiple
<b>Financials</b>	
Commonwealth Bank of Australia (CBA)	18.1
Virgin Money UK (VUK)	7.1
<b>Consumer Staples</b>	
Woolworths Group (WOW)	29.5
Metcash (MTS)	11.8
<b>Health Care</b>	
CSL (CSL)	45.3
Healius (HLS)	18.6
<b>Communication Services</b>	
Domain Holdings Australia (DHG)	54
Nine Entertainment Co Holdings (NEC)	15.5

### How much to pay for growth in a low-growth world?

While investors are happy to pay a premium for defensive names, they are also paying a premium for high-growth companies in IT and Health care. This is understandable given the disparity in opportunities at present. Many old-world companies face disruption to business models and are to be avoided. Low interest rates and low growth suggests those businesses with a solid growth opportunity deserve a premium, while some caution is warranted for the more extreme valuations. We remain cautious regarding some stocks facing disruption but see relative value in stocks with a solid growth outlook. We are particularly interested in opportunities where stocks with a solid, long-term opportunity come under pressure

due to Coronavirus or due to short-term earnings concerns. Stocks such as Seek look expensive, based on near-term multiples, and face risk from the virus outbreak, yet have a very strong long-term opportunity as they reprice their services and push into new markets. One way to examine the difference is to compare PEG ratios (a comparison of the PE versus growth of various players). Some growth names offer more attractive opportunities relative to the defensive names.

Company	Price/ Earnings to Growth Ratio
Crown Resorts (CWN)	21
GPT (GPT)	8
ASX (ASX)	8
Commonwealth Bank of Australia (CBA)	6
Coca-Cola Amatil (CCL)	4.5
SEEK (SEK)	1.8
Iress (IRE)	1.7
James Hardie Industries (JHX)	1.5
Treasury Wine Estates (TWE)	1.4

#### What would cause a further rotation into value?

The growth names above offer relative value in a growth constrained world. Deeper value tends to be in more problematic areas of the market (UK exposed, domestic building cycle, domestic retailers, casinos, financials) or in those areas with greater cyclicity such as resources. The opportunity for a further rotation into these stocks appears to be tied to a steepening of the yield curve or a pick-up in global growth. The major central banks are seeking to stimulate inflation (without much success). Political tension is increasingly focused on issues of income inequality and possible resolution could be aggressive fiscal stimulus and monetisation of debt. This can have a profound impact on the USD and long-term interest rates, which would have major implications for the leaders in the market.

At present the likelihood of such a rotation appears low. However, this is very much the consensus view. Modest signs of a pick-up in global growth have likely been pushed out by the Coronavirus outbreak. We have been modestly adding to some value opportunities across resource names.

#### Fund positioning and characteristics

Our current positioning is as follows:

- Quality at a reasonable price—SEEK (SEK).
- Value opportunities—Lendlease (LLC), Worley (WOR), Virgin Money UK (VUK), resources.
- Underweight expensive defensives.
- Underweight structurally challenged banks.

Current characteristics are as follows:

- The portfolio price-to-earnings ratio (PE) is lower than the market, despite better growth and a stronger return on equity (ROE), less debt and a better free cash flow (FCF) yield.
- Active share is 69%.

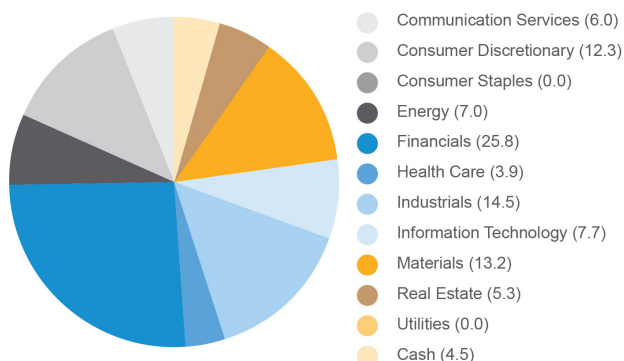
#### Key risks

Key risks to the portfolio include:

- **Interest rates:** low interest rates are the prime driver of markets at present. Any change to the inflation outlook would have significant impact on valuations.
- **Political environment:** it is an election year in the US, which adds potential uncertainty.
- **Growth:** potential disruption to global growth is largely expected by the market, so the alternative, which is a pick-up, could have a greater impact on valuations of defensive holdings.

## Portfolio attribution

### Sector weightings %



Source: DNR Capital

### Monthly - top contributors and detractors

Top 3 contributors		Alpha*
Resmed Inc	Overweight	0.28%
Link Administration Holdings	Overweight	0.26%
IPH	Overweight	0.21%

Top 3 detractors		Alpha*
Corporate Travel Management	Overweight	-0.58%
CSL	No Holding	-0.55%
Woolworths Group	No Holding	-0.27%

\* 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.

### 12 month - top contributors and detractors

Top 3 contributors		Alpha*
Breville Group	Overweight	1.91%
Lendlease	Overweight	1.44%
Resmed Inc	Overweight	1.37%

Top 3 detractors		Alpha*
CSL	No Holding	-1.78%
Link Administration Holdings	Overweight	-1.28%
Cash	Overweight	-0.87%

The top stock contributors were:

- ResMed (RMD)**—ResMed was up for the period following a strong quarterly result. The result showed flow generator sales maintained good positive sales momentum while mask sales surprised to the upside.
- Link Administration Holdings (LNK)**—Acquisition of Pepper European Servicing continued their expansion in Europe. The business provides loan servicing and asset management. The deal was circa 16% accretive once the synergies are extracted. While this is pleasing, we do not see the business as high quality, but it does diversify Link Administration Holdings' geographic diversity.
- IPH (IPH)**—IPH was up over the period on little news flow, as investors began shifting money in to businesses with low earnings risk ahead of reporting season. Businesses such as IPH that have defensive earnings also benefited from a rally in bonds during the period.

The top stock detractors were:

- Corporate Travel Management (CTD)**—Stock was hit as uncertainty grows around Coronavirus. Travel restrictions and bans should impact the company however, these should be temporary. While we expect some impact on near-term earnings, the share price has more than discounted this fact. Subsequently we think this is an opportunity as the virus doesn't impact the long-term cash flow and valuation of the business.
- CSL (CSL, no holding)**—CSL rallied on limited direct news flow as investors speculated that the company may upgrade its earnings outlook at the first half result.
- Woolworths Group (WOW, no holding)**—Woolworths Group continues to benefit from food inflation tailwinds, combined with strong execution on its customer-focused strategy. All supermarket stocks rallied in response the news that incoming German competitor Kaufland was withdrawing from its planned Australian entry. We continue to view Woolworths as a high-quality business. Despite its positive operating momentum, we see its current valuation as extreme, relative to its history and the market and maintain an underweight position.

## 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 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.



CERTIFIED BY RIAA

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**Office address**  
Level 23  
307 Queen Street  
Brisbane QLD 4000

**Postal address**  
GPO Box 3263  
Brisbane QLD 4001

**Telephone**  
07 3229 5531

**Email**  
[info@dnrcapital.com.au](mailto:info@dnrcapital.com.au)

**Website**  
[www.dnrcapital.com.au](http://www.dnrcapital.com.au)

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