The DNR Capital Australian Equities High Conviction Portfolio outperformed its benchmark for the period.

The S&P/ASX 200 Accumulation Index was up 8.78% during the period. The month was characterised by a broad-based recovery as investors were prepared to begin looking beyond COVID-19.

Energy (+22.0%) was an outperformer over the period as not only did OPEC+ come to an agreement on production cuts, the demand outlook also improved courtesy of the more positive economic sentiment. Information Technology (+22.5%) also outperformed due to companies’ sensitivity to improved growth assumptions and their strength of business models in the face of a pandemic.

Consumer Staples (+2.39%) was the worst performer in the period as the money-chasing defensive stocks of March sought better value in April. The defensive nature of Health Care (+4.38%) saw stocks similarly underperform in the April recovery.

Gross active return

<table>
<thead>
<tr>
<th></th>
<th>1mth %</th>
<th>3mth %</th>
<th>6mth %</th>
<th>1yr %</th>
<th>3yr %</th>
<th>5yr %</th>
<th>7yr %</th>
<th>10yr %</th>
<th>Incep.* %</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Conviction Portfolio</td>
<td>13.56</td>
<td>-22.38</td>
<td>-18.63</td>
<td>-10.87</td>
<td>0.72</td>
<td>4.64</td>
<td>7.60</td>
<td>8.37</td>
<td>11.07</td>
</tr>
<tr>
<td>S&amp;P/ASX 200 Accumulation Index</td>
<td>8.78</td>
<td>-20.32</td>
<td>-15.48</td>
<td>-9.06</td>
<td>1.92</td>
<td>3.46</td>
<td>5.38</td>
<td>5.96</td>
<td>8.19</td>
</tr>
<tr>
<td>Excess Return</td>
<td>4.78</td>
<td>-2.06</td>
<td>-3.15</td>
<td>-1.81</td>
<td>-1.20</td>
<td>1.18</td>
<td>2.22</td>
<td>2.41</td>
<td>2.88</td>
</tr>
</tbody>
</table>

* Inception date—October 2002

Excess return (calendar year)

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.
Markets bounced in April following the shock of the lockdown that caused markets to sell off through March. The bounce has surprised many market commentators, given the obvious stark economic impacts we can all observe. This month we discuss the bounce in markets, the ongoing gap between value and growth stocks, and the major opportunities presenting.

Is the market bounce justified?

The economy has hit a brick wall and the rally in stock markets is seemingly at odds with this clear economic reality. The economic collapse is unprecedented. Any number of charts highlights this. The dire numbers reflect the fact that economies are closed. Investors are looking through this short-term collapse and grappling with what earnings will look like on the other side of the crisis. Economies will not be shut forever, and it is important to value stocks based on long-term cashflows rather than on one or two quarters’ earnings.

Personal consumption expenditures

The fall in equity markets in March was also large by historical standards—a fall of 25% is a large pullback and the sharpness of the fall reflects economies grinding to a halt.

The COVID-19 crisis has caused unprecedented economic contraction and the question of whether policy support is enough to fill the economic hole remains. Our sense is that the fiscal packages launched so far are enough to stabilise the economy—they certainly are unprecedented by historical standards. Interestingly, the Australian fiscal spend is the largest in the world despite our lockdown being shorter than other nations. The OECD estimates that the aggressive containment policies will cause real GDP to be 1.5–2.5% lower for each month the lockdown is in effect. This implies an impact of around 6% from the initial shock, assuming an aggressive return to normal. This implies an output loss of around $1.6t in the US. The US government has enacted support packages valued at around $3t, which should offset the output loss. Adding the monetary efforts, the US is pumping in $7t into the economy. Global governments have reacted quickly and aggressively to this crisis—a sharp contrast to their behaviour in previous downturns.
Valuations

Understandably a key concern for market participants is the value of the market. Usually markets will bottom during a bear market at low multiples. In this downturn, multiples for stocks with greater economic sensitivity have traded cheaply, while those with defensive earnings or growth characteristics have remained elevated.

Relative PE of high value stocks versus low value stocks

Source: FactSet, Goldman Sachs Global Investment Research

We argued last month, and continue to argue, that markets have become very short-term focused during the crisis. It is difficult to value companies that have little short-term earnings, but therein lies the opportunity. Crowding into food retailers enjoying a profitable month selling toilet paper is a very short-term strategy. We talked to the Metcash (MTS) example last month, which was up 40% in March as investors chased the toilet paper trade. In April it reported its result, which failed to live up to expectations and the stock fell back 30%.

Robert Shiller’s cyclically adjusted price-earnings ratio and long-term interest rates

Source: Robert Shiller
Where to from here?

We see the following positive drivers for markets:

- Europe and US economies continuing to open and incremental positive news flow occurs as economies begin to recover. Policymakers appear to have made a conscious policy choice of reopening the economy while allowing for certain levels of infections and mortalities. This is “controlled herd immunity” and has become a public policy choice for most Western governments. This is good news for stocks, although not necessarily optimal from a public health point of view.

- Any signs of pent-up demand creating a positive early bounce in economies.

- Further news flow on vaccines, treatments and testing procedures to enable greater functionality of economies.

- Further evidence of the stimulus effect and further stimulus announcements.

The negative drivers from here include:

- A second wave of COVID-19 causing markets to shut down. This would further disrupt markets and have economic implications.

- Fallout from disputes between China and the US.

- Political failure to support further stimulus, should the economies need it.

It will take some time for the US economy to return to pre-COVID-19 levels, but this does not necessarily mean stock prices will have to retest their lows. Stocks and the economy often go separate ways, and this is especially so when there are powerful policy stimuli in the pipeline. Our focus is on finding quality companies at attractive valuations. Opportunities continue to be presented in a volatile environment.

Performance Report

April 2020

12 month - top contributors and detractors

Top 3 contributors

<table>
<thead>
<tr>
<th>Company</th>
<th>Alpha*</th>
</tr>
</thead>
<tbody>
<tr>
<td>James Hardie Industries</td>
<td>1.15%</td>
</tr>
<tr>
<td>ANZ Banking Group</td>
<td>1.14%</td>
</tr>
<tr>
<td>Domino's Pizza Enterprises</td>
<td>1.09%</td>
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</table>

Top 3 detractors

<table>
<thead>
<tr>
<th>Company</th>
<th>Alpha*</th>
</tr>
</thead>
<tbody>
<tr>
<td>CSL</td>
<td>-3.54%</td>
</tr>
<tr>
<td>Virgin Money UK</td>
<td>-1.48%</td>
</tr>
<tr>
<td>Link Administration Holdings</td>
<td>-1.19%</td>
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</table>

Monthly - top contributors and detractors

Top 3 contributors

<table>
<thead>
<tr>
<th>Company</th>
<th>Alpha*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tabcorp</td>
<td>0.74%</td>
</tr>
<tr>
<td>Lendlease</td>
<td>0.69%</td>
</tr>
<tr>
<td>Commonwealth Bank of Australia</td>
<td>0.60%</td>
</tr>
</tbody>
</table>

Top 3 detractors

<table>
<thead>
<tr>
<th>Company</th>
<th>Alpha*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury Wine Estates</td>
<td>-0.38%</td>
</tr>
<tr>
<td>Scentre</td>
<td>-0.23%</td>
</tr>
<tr>
<td>National Australia Bank</td>
<td>-0.21%</td>
</tr>
</tbody>
</table>

*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.

Portfolio attribution

The top stock contributors were:

- Tabcorp Holdings (TAH)—Outperformed as fears subsided over the closure of lotto retail outlets and the cancellation of racing events. Without further shutdowns, the company’s balance sheet position looks manageable and the likelihood of a large dilutive capital raising is unlikely. The competitive environment for wagering remains intense and the closure of pubs and clubs is likely to accelerate the move to digital. The lotteries business, making up approximately 70% of the valuation, has continued to trade well through the crisis.

- Lendlease Group (LLC)—Outperformed following a $950m capital raising which left the company with close to $4b in liquidity. Management noted the current market is likely to provide opportunities to deploy capital into accretive development projects and funds. They provided a solid progress update on existing projects and reiterated previously exit costs for their engineering and services business.

- Commonwealth Bank of Australia (CBA, no holding)—Underperformed over the period as banks were weak on expectations of capital raisings and further provisions amid the uncertainty of COVID-19.
The top stock detractors were:
- Treasury Wine Estates (TWE)—Underperformed over the period as investors grappled with both the potential spin off of the Penfolds brand and demand in the Chinese market only slowly recovering despite China’s economy returning to normal. Political tensions between Australia and China added extra pressure to the outlook with the wine being explicitly mentioned as being at risk in trade dispute.
- Scentre (SCG, no holding)—Outperformed over the period as the retail REIT sector recovered strongly from last month’s declines. Many of the concerns surrounding the balance sheet risk of these businesses eased during the month. Having avoided a worst-case scenario, the market grew increasingly confident in the ability for retail to recover in a post-COVID-19 world.
- National Australia Bank (NAB)—Underperformed over the period as banks were weak on expectations of capital raisings and further provisions amid the uncertainty of COVID-19.

Portfolio positioning

Our current positioning is as follows:
1. Overweight market leaders like Aristocrat Leisure (ALL), James Hardie (JHX), SEEK (SEK), REA Group (REA), Domino’s Pizza Enterprises (DMP), Ramsay Health Care (RHC), Cochlear (COH).
2. Overweight resources that can benefit from stimulus and continue to operate and earn revenues.
3. Increased to a basket of mid-cap companies with strong market positions like ALS (ALO), Qube Holdings (QUB), Cleanaway (CWY).
4. Underweight banks given they are highly leveraged to the economy and medium-term profits are impacted by lower interest rates and higher bad debts.
5. Underweight defensives like Woolworths Group (WOW), Coles Group (COL) and CSL (CSL) that have benefitted in the short term from resilient earnings but do not offer the upside that other areas of the market provide.

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 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. Further geopolitical uncertainty could create negative implications for stocks and portfolios.
- Growth. Rising interest rates in the US increase the risk of an economic slowdown. Potential disruption to global growth is largely expected by the market so the alternative, which is a pickup, could have a greater impact on valuations of defensive holdings.
- Emerging market risks. Implications of slowing growth in emerging markets and impacts from currency instability.

Portfolio moves

Purchase of Suncorp Group (SUN)

Suncorp Group is under new management, which is a good thing after poor performance under previous leadership that saw it behave more like a bank than a general insurance player. It trades at a large discount to IAG and similar to the major banks despite having more resilient earnings. Suncorp Group is in a good position to pay a dividend and thereby differentiate itself from other financial players. New management should ensure the business operates effectively and efficiently and improves returns.

Suncorp Group meets DNR Capital’s five-point quality web:
1. Industry structure—Suncorp Group is largely an insurance player and the insurance market has two main players in the retail market. It has scale benefits particularly in handling claims, which gives it a competitive advantage over newer entrants (albeit they might be able to cherry pick some attractive segments).
2. Earnings strength—It has less exposure to high-risk banking areas (institutional, commercial real estate) relative to the major banks and has significant reinsurance in place and conservative investments. Consequently, it is in a good position to continue to earn solid earnings this year. In addition, with fewer cars on the road and people at home, motor vehicle and home insurance claims are down significantly.
3. Balance sheet—The company has excess capital after selling its smash repair business, which means it should be well placed to continue to pay dividends. We estimate it has around $700m of excess capital.
4. Management—It has suffered under poor leadership for a number of years. We rate the new CEO highly and he is introducing a simple strategy focused on better execution—playing to its strengths (reinvigorating Suncorp brand in Queensland and AAMI in NSW), operating efficiently and handling claims more effectively. We envisage this will involve reinvigorating culture and making changes to leadership and structure to drive greater accountability.
5. Environmental, social and governance (ESG)—Relative to the banks Suncorp is lower risk from an ESG perspective. It has suffered fewer reputational hits as a consequence.
Valuation
From a valuation perspective Suncorp Group trades at 10x one-year forward earnings with a 5.25% fully franked yield with the potential to grow earnings steadily as it reinvigorates the franchise.

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 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.