Australian Equities Income Portfolio

Performance Report – September 2020

Market overview and portfolio performance

Scott Kelly
Portfolio Manager

Jamie Nicol
Chief Investment Officer

The DNR Capital Australian Equities Income Portfolio outperformed its benchmark for the period. Key stock contributors were SKYCITY Entertainment Group (SKC), ANZ (ANZ) and the Commonwealth Bank (CBA, no holding). Key stock detractors were CSL (CSL, no holding), Virgin Money (VUK) and Tabcorp Holdings (TAH).

The S&P/ASX 200 Industrials Accumulation Index was down 3.23% during the period. Health Care (+0.4%) was the best performing sector during the month as both Sonic Healthcare (SHL) +3.7% and Cochlear (COH) +3.1% outperformed. Industrials (-0.7%) also fared better than the market, with Sydney Airport (SYD) +8.1% rallying ahead of peers. Consumer Staples (-8.2%) was the worst performing sector, with Woolworths (WOW) -8.6% and Coles (COL) -4.1% both struggling after outperforming during the COVID-19 lockdown period. Information Technology (-6.9%) also underperformed, both Afterpay (APT) -12.3% and Wisetech (WTC) -8.5% retracing after strong rallies in previous months.

Portfolio overview

Investment bias	Style neutral
Designed for	Investors who seek a greater level of income and who can make use of franking credits
Benchmark	S&P/ASX 200 Industrials Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Industrials Accumulation Index and deliver higher levels of income (before fees) over a rolling three year period
Investable universe	ASX listed securities with a focus on S&P/ASX 200
Number of stocks	15–30
Asset allocation	Australian equities 80–100% Cash 0–20%
Portfolio stock limit	15% maximum weighting
Minimum suggested investment timeframe	5 years

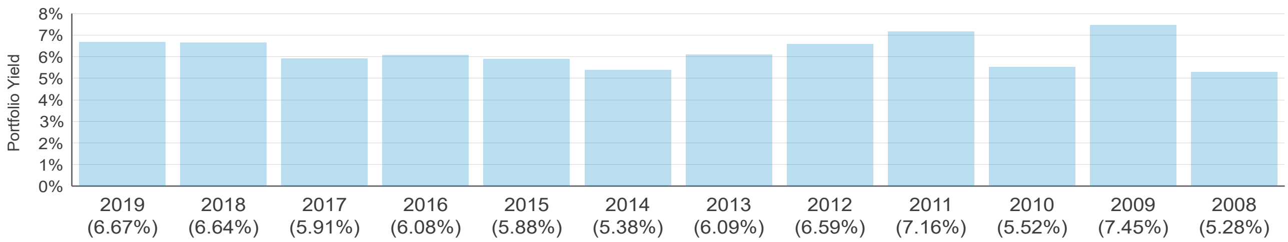
The Portfolio's dividend yield expectation for calendar year 2020 is currently 3.55% (4.65% grossed up for franking credits).

Gross active return

	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Income Portfolio	-2.00	-0.53	24.05	-12.54	3.47	6.36	7.12	10.35	6.37
S&P/ASX 200 Industrials Accumulation Index	-3.23	-0.47	13.40	-11.70	3.31	5.86	6.20	8.76	4.56
Excess Return	**1.23**	**-0.06**	**10.65**	**-0.84**	**0.16**	**0.50**	**0.92**	**1.59**	**1.81**

** Inception date—December 2007*

Grossed-up yield (calendar year)*



**Gross yield calculation uses income (including franking credits) ex-date and applies a monthly capital rebasing over the 12 month period (January to December).*

Source: DNR Capital

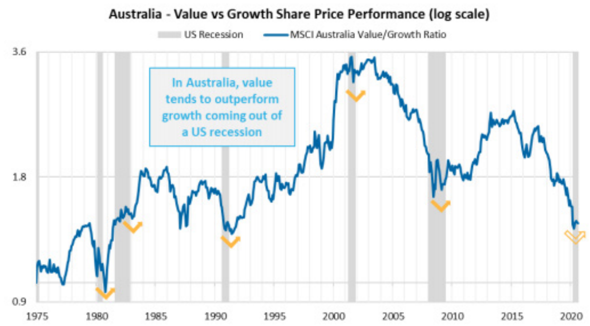
Performance data relates to the DNR Capital model portfolio. Performance of an investment in this model portfolio through a Portfolio Service may have different performance to the performance in this monthly update as a result of different policies and procedures at different Portfolio Service operators. 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

Equities across the globe have rebounded sharply since the bottom in March. This is despite COVID-19 disruption remaining in most countries. The market appears to be anticipating a recovery in the expectation of a vaccine and assisted by stimulus. We note however that the segments of the market that have been strongest tend to be those areas least impacted by COVID-19 so it would appear that the low interest rates and lack of alternative investments is the prime drivers.

There is likely to be increased volatility into the end of 2020, as a number of uncertainties and risks play out. However, optimism of a reopening of the economy should pave the way for an expansion into 2021, with cyclicals likely to outperform defensives and value to outperform growth.

Australian value has outperformed growth coming out of US recession



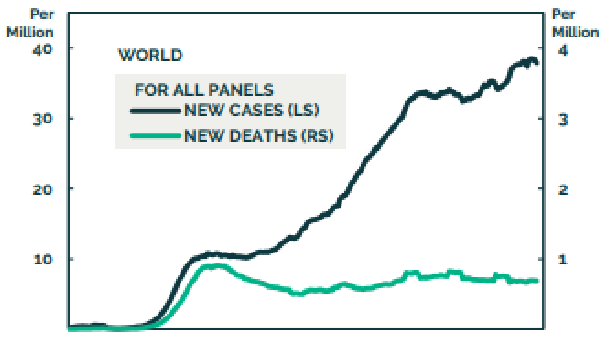
Source: FactSet, Macquarie Research

Global growth faces near-term challenges from a number of major uncertainties:

COVID-19 cases increasing

The renewed spike in the number of COVID-19 cases, particularly in Europe, is threatening the ongoing economic recovery. The global number of daily new cases continues to trend higher, with the seven-day average reaching a record high of nearly 300,000. While governments are unlikely to impose the same restrictions experienced in March, reopening plans may be delayed and stricter social distancing rules may be reintroduced.

Globally, the number of daily new cases continues to trend highter



Source: BCA Research

Second US fiscal stimulus package

Negotiations have stalled between the Democrats (who want a bigger package) and the Republicans, with neither side appearing willing to make major compromises. The risk here is twofold, 1) similar to the Troubled Asset Relief Program (TARP) program in 2009, it took a sharp sell-off in stocks to force policymakers to move, and 2) without a second bipartisan package, the US economic recovery would be under significant pressure. That said, some compromise may still eventuate with the nearing election in early November.

US election

The November presidential election is approaching. The probability of either candidate being a clear winner is low. However, as Trump's polls have waned the market has rallied as the risk of the contested results eases. President Trump is refusing to commit to a peaceful transfer of power and the odds of a contested election result are rising, as is the likelihood that the Supreme Court will need to determine the winner. Betting markets and financial markets currently expect Biden to become president and the Democrats to also gain control of the Senate. Given the Biden/Democrat policy for raising taxes, democratic sweep is likely to be negative for equities in the short term, albeit we expect this would be offset in time by higher infrastructure expenditure and greater stability in geopolitics.

The potential consequences of a Biden victory are as follows:

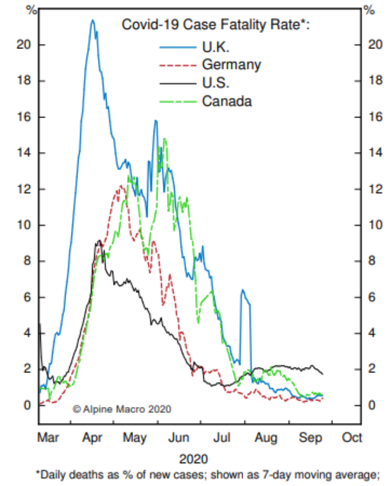
- Higher taxes over time which would be a negative for markets.
- More aggressive fiscal stimulus which would support cyclical parts of the market.
- Acceleration of environmental spending which likely supports renewables but would be negative for oil sector.
- Regulatory oversight of Wall Street which would be negative for Investment Banks.
- Regulation of big pharma.
- Potential regulation of large tech.

However, growth should revive next year for the following reasons:

COVID-19 mortality rate is falling

There has been a significant reduction in the COVID-19 mortality rate in most countries across the developed world. This is likely to be due to better treatment being available and increasing infections in younger and healthier people. There is also some speculation that the virus is evolving to become more contagious, but less deadly and that mask wearing may be mitigating the severity of disease by reducing the initial load that is received, allowing the immune system more time to counterattack.

A sharp fall in Covid-19 mortality rate

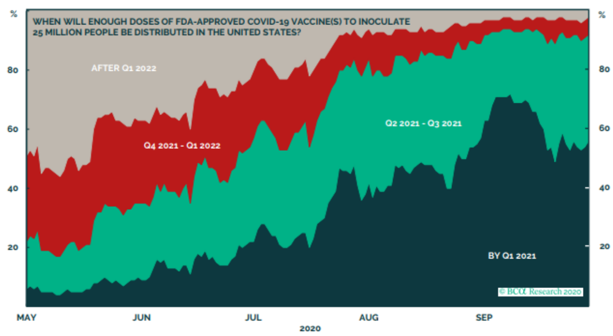


Source: European Centre for Disease Prevention & Control

Likelihood of a vaccine is increasing

A vaccine is important in that it will allow restrictions to be lifted and economies to recover. There are ~150 vaccines currently under development around the world. While it is likely that a vaccine will be found, the timing is very difficult to predict, particularly with respect to mass production and distribution. About half the experts polled by the Good Judgement Project expect a vaccine to become widely available by the first quarter of 2021, up significantly from May. The frontrunners (AstraZeneca, Moderna, Pfizer/BioNTech) are advancing quickly with first supply potentially available by the end of the year, assuming clinical development succeeds.

When will a vaccine become available?



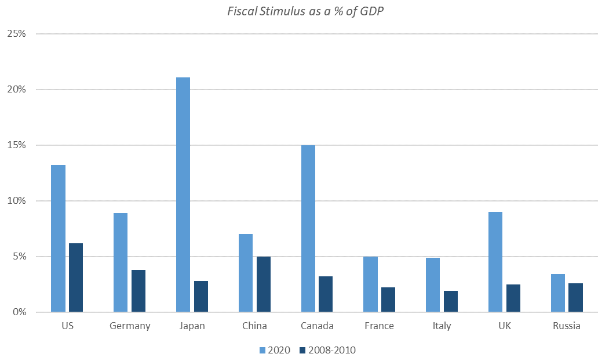
Source: Good Judgment Inc

Fiscal stimulus ongoing

The size of the fiscal stimulus across the globe is extraordinary. At around 9% of GDP it dwarfs the stimulus during the GFC and dwarfs most economic periods over the past 100 years. The US is spending trillions and we expect further trillions to be spent post the US election.

There is no appetite for fiscal austerity, with all sides of politics moving in a populist direction. This has been evidenced in the UK, France, the Euro region more broadly, and Japan. As long as interest rates remain low, fiscal policy is expected to remain accommodative.

Fiscal stimulus is greater than it was during the GFC



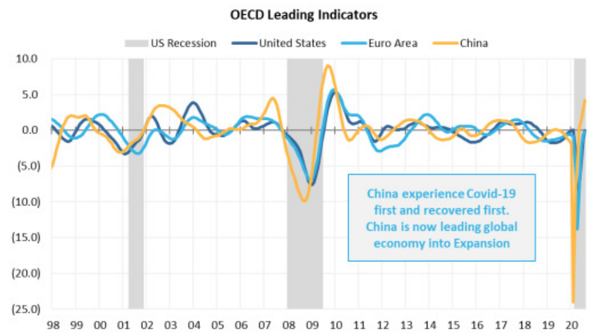
Source: DNR Capital, the IMF 2020

In Australia we are seeing further stimulus being introduced. The Federal Budget introduces $98b in new spending and $50b in tax cuts. Josh Frydenberg's second budget is structured to cushion the economy as the government begins winding back its COVID-19-related economic support and to incentivise business to lead the recovery through investment and jobs.

China recovery leading the way

China experienced COVID-19 first and is recovering first. Following a 10% decline in GDP in 1Q, relaxing restrictions and substantial fiscal and monetary support saw GDP rebound by >11% in 2Q. China is now the only major economy expected to grow in 2020 and 2021 and is leading the global economy into expansion.

China is leading the global economy into the expansion phase of the cycle



Source: FactSet, Macquarie Research

Dividend opportunities

While 2020 has been a challenging time for income-seeking investors, we are seeing some compelling opportunities. We continue to position the portfolio in high-quality businesses that offer a combination of attractive dividend yields, growth, franking benefits and importantly, valuation support. Some examples are summarised below:

Compounder – IPH (IPH): IPH provides a wide range of services across intellectual property, patent and trade mark products across Australia, New Zealand and Asia. Its defensive characteristics, robust patent filing volumes and strong progress on the synergies from recent acquisitions were key highlights from reporting season. There have been foreign exchange (FX) headwinds over the last couple of months, which has seen share price weakness and has provided great opportunity in our view.

The market is yet to give much credit for its expansion strategy. Potential acquisitions should serve as a catalyst for the share price. In the meantime, the stock is delivering a ~6% pa gross yield with high, single-digit growth.

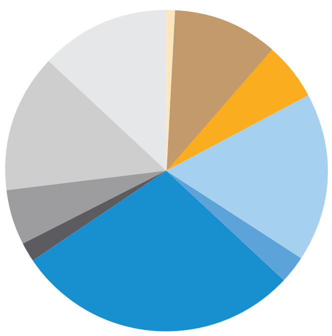
Grower – Atlas Arteria (ALX): Following a significant decline in traffic, Atlas Arteria cancelled its usual March dividend. Traffic has since returned to pre-COVID-19 levels on the main asset in France. Atlas Arteria expects to pay a dividend of 11cps later this month and dividends are expected to increase substantially over the next 12-18 months. Normalised traffic volumes and a simplified corporate debt structure imply a sustainable dividend of up to ~40cps, which represents a yield of ~6% pa at current prices. There is further upside as management looks to restructure debt on the Dulles Greenway and Warnow tunnel to unlock cash at these assets.

Cow – Aurizon Holdings (AZJ): Aurizon is one of our most favoured portfolio stocks. In the short term, the market is cautious about coal volumes, however we expect a recovery in the 2H as China and India get back to work. The network is a misunderstood asset with defensive characteristics, while the bulk turnaround has been a standout. The stock is trading cheaply and has an attractive and sustainable yield profile of >7% pa including franking. In addition, the company has ~$1.2b of balance sheet capacity, so capital management support in the form of on-market buybacks will be ongoing.

Yielder – Telstra Corporation (TLS): Telstra has not been immune to COVID-19 disruption with some negative one-off impacts from lower international roaming charges, customer incentives and delayed synergies hitting both FY20 and FY21 earnings. The market appears to have focused on the risk to the 16cps dividend from a lowering of near-term ROIC targets. We believe that ~$7.5b EBITDA is achievable by FY23 and as such, the 16cps dividend remains sustainable. The competitive environment in mobile remains rational and is likely to see improving earnings over the next few years and we also expect Telstra will recover lost earnings from disruption caused by COVID-19.

Portfolio attribution

Sector weightings %



Source: DNR Capital

Monthly - top contributors and detractors

Top 3 contributors		**Alpha***
SKYCITY Entertainment Group	Overweight	0.87%
ANZ Banking Group	Underweight	0.40%
Commonwealth Bank of Australia	No Holding	0.35%
Top 3 detractors		
CSL	No Holding	-0.42%
Virgin Money UK	Overweight	-0.36%
Tabcorp Holdings	Overweight	-0.23%

12 month - top contributors and detractors

Top 3 contributors		**Alpha***
ANZ Banking Group	Underweight	1.85%
James Hardie Industries	Overweight	1.48%
Super Retail Group	Overweight	1.32%
Top 3 detractors		
CSL	No Holding	-2.86%
Lendlease	Overweight	-1.20%
National Australia Bank	Overweight	-1.09%

** 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:

- **SKYCITY Entertainment Group (SKC):** Reported a strong result that highlighted the strength of the core gaming business. The company gave indications around current trading levels, which were well above market expectations. Subject to no further shutdowns, SKC expects to resume paying dividends next calendar year.
- **ANZ Banking Group (ANZ):** Sector underperformed given margin uncertainty in today's low interest rate environment and the potential bad debts on its balance sheet. Previously no holding, we acquired ANZ shares towards the end of the month.
- **Commonwealth Bank of Australia (CBA, no holding):** Sector underperformed given margin uncertainty in today's low interest rate environment, and the potential bad debts on its balance sheet.

The top stock detractors for the month were:

- **CSL Limited (CSL, no holding):** Outperformed after a period of relative weakness as collection centre volumes showed signs of gradual improvement. The market is expecting a further update on guidance at the AGM in October and expectations are that the guidance range could be narrowed towards the upper end of the current range of 0–8% growth.

- **Virgin Money UK (VUK):** Underperformed as, like the Australian banks, VUK is struggling in today's low interest rate environment. Underperformance has been compounded by both the resurgence of COVID-19 cases in the UK and Brexit getting to the pointy end.
- **Tabcorp Holdings (TAH):** Underperformed the market as the rolling shutdowns in Victoria continued to delay the earnings recovery in retail wagering. The lotteries business, which makes up most of the valuation, continues to trade well.

Portfolio characteristics

We continue to position the Portfolio in high-quality businesses that offer a combination of attractive dividend yields, growth, franking benefits and importantly, valuation support.

Our portfolio of quality names with attractive risk-return characteristics should deliver a growing dollar income outcome through the cycle.

The Income Portfolio is expected to generate a gross yield of 4.65% (including franking) for calendar year 2020, very attractive relative to alternatives.

1. The quality characteristics of the portfolio are attractive relative to the portfolio's benchmark:

   a. 2-year forward return on equity is in line with the market at 8%.

   b. 2-year forward dividend yield is 4.7% compared to the benchmark at 3.8%.

   c. 2-year forward earnings growth and dividend growth expectations above market growth rates at ~ 17% and ~ 26% respectively compared to ~14% and ~ 21% for the benchmark.

2. Despite having stronger growth and quality characteristics relative to the market, the valuation is more attractive:

   a. 2-year forward PE is at 15.3x compared to 18.5x for the benchmark.

3. In addition, despite the superior growth outlook, the defensive attributes of the portfolio have been maintained:

   a. 2-year forward free cash flow yield is ~6% compared to the benchmark at ~4%.

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. Further geopolitical uncertainty could create negative implications for stocks and portfolios.

Portfolio positioning

The below summarises our current Portfolio positioning:

- A basket of stocks with defensive characteristics at attractive valuations - Atlas Arteria (ALX), Aurizon Holdings (AZJ), Coles Group (COL), IPH (IPH) and Telstra Corporation (TLS).
- Selective exposure to COVID-19 impacted stocks with quality characteristics - Ramsay Health Care (RHC), Scentre Group (SCG), SKYCITY Entertainment Group (SKC), Sydney Airport Holdings (SYD)
- Underweight Australian banks - Negatively correlated to low interest rates and bad debts. National Australia Bank (NAB) preferred. No Commonwealth Bank of Australia (CBA) holding. Prefer other financials - Macquarie Group (MQG), Suncorp (SUN), Insurance Australia Group (IAG), Virgin Money UK (VUK).
- Overweight consumer stocks that should benefit from stimulus in recovery phase - Tabcorp Holdings (TAH), Wesfarmers (WES), Super Retail Group (SUL).
- Select exposure to quality growth stocks - REA Group (REA), SEEK (SEK).
- Overweight global cyclicals, resources and energy - James Hardie Industries (JHX), Lendlease Group (LLC), BHP Group (BHP), Woodside Petroleum (WPL).

Portfolio categories

At DNR Capital, we categorise income-generating companies as:

Growers: High-conviction stocks that may be paying a below-market dividend yield, however we see a clear path towards delivering a sustainable and growing income profile in the medium term.

Compounders: Quality stocks operating within a robust industry structure that have a strong competitive position, underpinning attractive and sustainable income growth.

Cows: Stocks with a solid balance sheet and capital management potential that are being undervalued on traditional earnings-based metrics.

Yielders: Quality companies at attractive valuations that are delivering sustainable and cash-backed dividends, however with little growth.

Stock moves

Purchase of Insurance Australia Group (IAG)

IAG is the largest general insurer in Australia and represents the umbrella organisation that holds many well-known insurance brands, including NRMA and CGU.

IAG meets DNR Capital's six-point quality web:

1. **Industry structure:** IAG and Suncorp Group (SUN) dominate the domestic retail insurance sector with >70% market share. This is one of the strongest structures globally. In addition, IAG has the leading position in commercial insurance with more than 25% share. While online players have taken share in recent years they have struggled to process claims and have attracted numerous complaints.

2. **Earnings strength:** Returns are improving as prices rise. Furthermore, a deal with Berkshire Hathaway has reduced earnings volatility and enhanced profit margins.
3. **Balance sheet:** Capital levels remain strong. FY20 Common Equity Tier 1 (CET1) ratio of 1.23x, is well above the 0.6x APRA minimum required.
4. **Management:** IAG recently appointed the previous CFO, Nick Hawkins to the CEO role. He has flagged that simplification is a key priority.
5. **Environmental, social and governance (ESG):** IAG has modest risks across ESG areas. A key risk is that insurance can suffer major catastrophes, although we note that IAG has significant levels of reinsurance in place and a quota share arrangement with Berkshire Hathaway.
6. **Income sustainability/growth:** Dividends (FY21–23 underlying dividend yield of 5–6% plus 100% franking) are supported by underlying earnings and a solid balance sheet.

Key risks

Business interruption (BI) claims. The Insurance Council of Australia (ICA) and Australian Financial Complaints Authority (AFCA) are launching two industry test cases to resolve uncertainty on whether SME policies cover BI. We think that the market is pricing in BI losses in the range of A$1–2b, compared to a provision of ~$100m.

Pricing/margins. With lack of guidance at the last result, the near-term outlook lacks visibility. That said, we believe margin expectations have been rebased by the market and there may be upside to expectations through repricing.

CAT losses. A catastrophic loss resulting from a severe event could impact near-term profitability and IAG's capital position.

Valuation and thesis. IAG's outlook has been impacted on multiple fronts with lower top-line growth, rising input costs, long-tail claims inflation, slowing reserve releases, investment headwinds, and higher operating costs. While headwinds are likely to persist in the current economic climate, we see FY21e as a trough year for underlying margins, with recovery post COVID-19 where IAG should have greater ability to restore margin through stronger repricing. A positive outcome on BI test cases could provide a positive catalyst. Recent share price weakness has provided an opportunity to re-enter the stock. With the stock trading on ~16x FY22e (post COVID-19) earnings, we see value appeal. A 5–6% dividend yield plus franking is also attractive in the current environment.

Sale of Amcor (AMC)

We have exited our position in AMC to fund new stock purchases. The stock is trading at a full valuation and a premium to global peers. We remain attracted to AMC's underlying assets and defensive qualities, however the stock has been a recent beneficiary of at-home consumption and much of its expected FY21e growth of 5–10% is likely to be driven by Bemis acquisition synergies. We see better risk/reward opportunities elsewhere.

Sale of Rio Tinto (RIO)

We have exited our position in RIO. We believe commodity prices, particularly iron ore, are unsustainably high due to the supply imbalance resulting from the dam-wall issues and COVID-19 disruption in Brazil. As such, we have tactically reduced our exposure to resource and energy companies, particularly given that they are excluded from the Portfolio's benchmark (the S&P ASX 200 Industrials Index). Our preferred exposures remain BHP and WPL, due to the embedded upside in a recovery from higher oil prices which has been negatively impacted by demand destruction resulting from lockdowns.

Banks' portfolio moves

We have exited our position in Westpac Banking Corporation (WBC) and added Australia and ANZ. ANZ offers value trading below its peers (~0.8x price-to-book, versus WBC and National Australia Bank (NAB) on ~0.9x and CBA on ~1.5x). ANZ also has greater leverage to an improving economy as asset quality concerns subside. Currently the crisis has largely not migrated to institutional business (ANZ's strength), ANZ continues to grow mortgage lending, has a large exposure to the foreign exchange volatility given the size of its market's business and the capital position is robust. On the other hand, WBC's CET1 looks particularly weak in the absence of asset sales. We have a -7% underweight position across the Big 4 Banks due to:

1. Limited asset growth (reduced borrower risk appetite)
2. Falling forward net interest margin (NIM) trajectory (low rates, competition)
3. Falling fees (activity levels, switch from credit to debit)
4. Sticky costs (eg call centre/collection staffing, regulation and compliance)
5. Possible further bad debt provisioning as uncertainty remains, at the same time as regulatory capital credit risk weightings rise.

Dividends are expected to bottom in FY20, with net yields of 5–6% (plus franking) expected in FY21 and beyond, albeit with minimal growth in the current low interest rate environment.

Investment strategy

The Australian Equities Income Portfolio has an investment style best described as 'style neutral' with above-average income and associated franking credits. The security selection process has a strong bottom-up discipline and focuses on buying quality businesses at reasonable prices.

The Australian Equities Income Portfolio also has a preference for securities that have high and sustainable dividend capability, strong profit-to-cash conversion, and relatively assured earnings growth. Securities that generate franking credits predominate.

We define quality businesses as being those with the following six attributes:

- earnings strength (particularly improving return)
- superior industry position
- a sound balance sheet
- strong management
- low environmental, social and governance (ESG) risk
- Income sustainability / growth

The focus of the portfolio is on yield. We are focused on a growing, sustainable dividend yield above the market.

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)
- Coloinal First State FirstWrap
- Federation Alliance
- HUB24
- Linear
- Macquarie Wrap
- Mason Stevens
- Netwealth
- OneVue
- Powerwrap
- Praemium
- Wealthtrac

Disclaimer

This document has been prepared by DNR Capital Pty Ltd, AFS Representative - 294844 of DNR AFSL Pty Ltd ABN 39 118 946 400, AFSL 301658. It is general information only and is not intended to be a recommendation to invest in any product or financial service mentioned above. Whilst DNR Capital has used its best endeavours to ensure the information within this document is accurate it cannot be relied upon in any way and you must make your own enquiries concerning the accuracy of the information within. The information in this document has been prepared for general purposes and does not take into account the investment objectives, financial situation or needs of any particular person nor does the information constitute investment advice. Before making any financial investment decisions you should obtain legal and taxation advice appropriate to your particular needs. Investment in a DNR Capital managed account can only be made on completion of all the required documentation. DNR Capital does not guarantee the repayment of capital from the portfolio or the investment performance of the portfolio.

If you have invested in the Australian Equities Income Portfolio via a service such as investor directed portfolio service, managed account service or separately managed account ('Portfolio Service'), you can obtain information from the Portfolio Service operator. If you invest via a Portfolio Service, different terms may apply to your investment. You should read the disclosure document for that Portfolio Service and consider your circumstances prior to investing.

Office address	Postal address	Telephone	Email	Website
Level 23 307 Queen Street Brisbane QLD 4000	GPO Box 3263 Brisbane QLD 4001	07 3229 5531	info@dnrcapital.com.au	www.dnrcapital.com.au

DNRINCR .4.15.2009