DNRCapital

Australian Equities Socially Responsible Portfolio

Performance Report – April 2019

Market overview and portfolio performance

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The S&P/ASX 200 Accumulation Index was up 2.37% in April, continuing the upbeat start to the year. Consumer Staples (7.4%) were the strongest performers during the month as signs of inflation began to emerge in grocery and investors consider the effect of a potential rate cut on the consumer. Information Technology (7.3%) was a top performer as the prospect of lower interest rates increased investors' risk appetite and also added valuation support. Property (-2.6%) fared the worst over the period, as the risk-on sentiment saw investors move somewhat out of bond proxies and into higher-growth opportunities. This theme also hit Utilities (-0.47%) which has been a point of safety for some investors.

The DNR Capital Australian Equities Socially Responsible Portfolio outperformed its benchmark for the period.

Portfolio overview

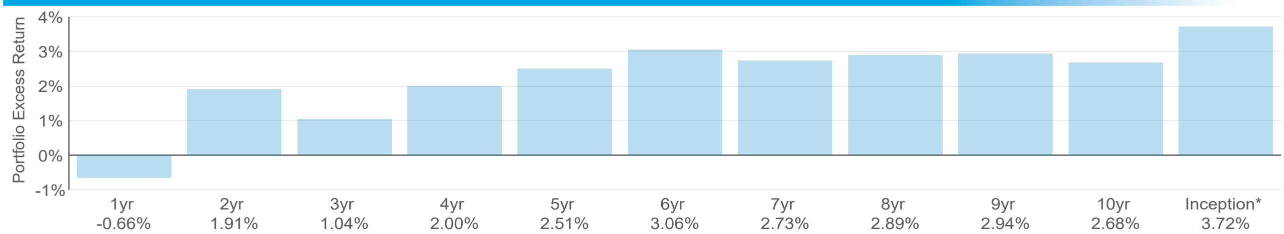
Investment bias	Style neutral
Designed for	Investors who want a competitive return but do not want investments judged to have involvement in gaming, pornography, armaments and tobacco
Benchmark	S&P/ASX 200 Accumulation Index
Investment objective	To outperform the S&P/ASX 200 Accumulation Index by 4% 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

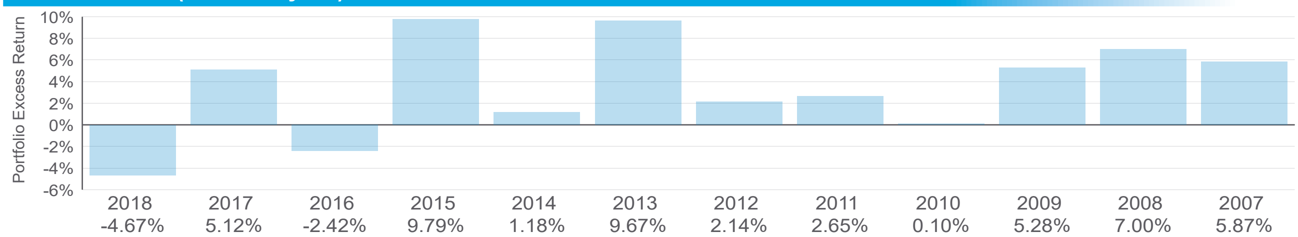
	1mth %	3mth %	6mth %	1yr %	3yr %	5yr %	7yr %	10yr %	Incep.* %
Socially Responsible Portfolio	3.13	13.60	9.96	9.75	12.14	10.03	12.84	12.69	10.15
S&P/ASX 200 Accumulation Index	2.37	9.29	10.87	10.41	11.10	7.52	10.11	10.01	6.43
Excess Return	**0.76**	**4.31**	**-0.91**	**-0.66**	**1.04**	**2.51**	**2.73**	**2.68**	**3.72**

** Inception date—June 2006*

Annualised excess return



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.

Portfolio review

Repositioning over the past six months

The purpose of this report is to highlight the positioning undertaken by the portfolio over the past six months. To recap, during the December quarter, we experienced underperformance as the market concerns regarding slowing growth resulted in outperformance by property trusts, infrastructure assets and gold. In addition, in a risk-averse market, specific stock issues resulted in exaggerated pullbacks in a range of stocks, especially those with cyclical exposure.

The volatility in the market created opportunities to buy quality companies at attractive, and at times, distressed prices. Following a strong reporting season for our companies we feel confident that we were able to deploy capital into a range of attractive companies at attractive valuations. These will offer rewards in time.

Moves in the December quarter

During this period we saw bids for MYOB Group (MYO) and Healthscope (HSO), as well as some defensive stocks holding up quite well. As a result, we used these positions and cash held as funding to take advantage of the significant opportunities that emerged.

We took advantage of the opportunities that emerged and in nine weeks we invested approximately 10% of the portfolio in a range of quality companies.

We have added to numerous positions offering the highest excess returns and now have six positions with active weights more than 4% higher than the benchmark and five positons more than 3% higher than benchmark. The portfolio has an active share of 66%, which reflects the high level of conviction we have in the outlook for the portfolio.

Key positions added during weakness included ResMed (RMD), Link Administration Holdings (LNK) and WorleyParsons (WOR).

The markets bounced since year end due to easing of some of the risks overhanging the market.

The following factors drove this easing in the risk outlook:

1. The US Federal Reserve Chief suggested US interest rates were near neutral, which suggests the pace of change will ease—a pause in interest rate rises ease fears of further tightening.
2. The US and China have reported strong progress in negotiating a trade deal.

As the quarter progressed tension, emerged between a negative yield curve, which has been a recession indicator in past cycles, and better economic data from the US and China.

These are our major moves since year end. We have:

1. Rebuilt cash as dividends were paid which provides options for further volatility.
2. Lightened strong performers Breville Group (BRG), IRESS (IRE), IPH (IPH) and ALS (ALQ).
3. Continued to lighten Healthscope where needed.
4. Increased positioning in high-quality names like Wesfarmers (WES), REA Group (REA), and SEEK (SEK). These companies have been a little soft on short-term concerns with the domestic economy, but this has masked longer term opportunities as they expand the size of their addressable market (new adjacencies, new products and new geographies).
5. Added two new positions.

- ARB Corporation (ARB) given the size of de-rating and long-term alignment with management.
- Suncorp Group (SUN) to add to defensiveness of the portfolio and as a relative to banks.

Current portfolio statistics

Following this very active positioning we note the following:

1. The quality characteristics of the Portfolio have improved as we have added to good companies during the volatility:

- Return on equity (ROE) is above the market at 13.5% (11.8% for the market) and the ROE trend is better than the market.
- Earnings growth and dividend growth expectations are above market growth rates at 8% and 4.5% respectively, compared to 4% and 1% for the market.
- Gearing levels are below market expectations with the Portfolio at 0.9x net debt(ND)/earnings before interest, taxes, depreciation and amortisation (EBITDA), compared to the market at 1.9x.

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

- Price earnings ratio (PE) is at 15x in line with the market.
- Dividend yield is in line.

3. Conviction levels remain strong and present opportunities to deliver outperformance:

- Active share of 69%.
- Tracking error 4%.
- Top six positions active weight of >4%.
- Next five > 3%.

The portfolio performed well during February when a large proportion of the stocks held delivered strong results. It remains underweight to property trusts and infrastructure stocks, which means lower bond yields continue to present a headwind noticeable in March, but which reversed in April. We remain of the view that risk aversion has meant too much money has chased these stocks, bidding up valuations and note that these companies need bond yields to continue falling to maintain momentum. Our portfolio of quality names offers attractive risk-return characteristics, which we would expect to deliver through the cycle.

Over the past two months, analysts from our team have visited China and Japan and have attended the Macquarie Australia Conference 2019 where we discussed the economic outlook with a range of companies and observed trends emerging in the market. This report highlights some of the key trends presently impacting markets and companies, and then discusses the rationale of our portfolio positioning over the past six months which has been a volatile period for the market.

Information Technology (IT) opportunities compared to valuations

Most companies we speak to are spending money digitising their processes, incorporating the use of robotics, artificial intelligence (AI) and/or data analytics, or thinking about the potential for electronic vehicles or 5G. Retailers are investing more in robotics and process automation as the internal rate of return (IRR) of these projects becomes more attractive as labour costs rise. From an investment perspective there are opportunities for traditional companies to improve productivity using technology. An example of this is Coles Group's (COL) new relationship with Ocado® Technology. National Australia Bank (NAB) is digitising its mortgage processes and Brambles (BXB) is using robotics to lower the cost of maintaining pallets. Whether these productivity improvements will be competed away remains to be seen, but for many traditional companies we think this will be the case. Nonetheless, it is a spend that is needed to prepare for the future.

We are invested in a range of companies operating software as a service (SaaS) or involved in digitisation of processes. An example is IRESS, which provides software to financial services companies and should benefit in an environment of increased complexity and regulation. Further digital businesses like SEEK and REA Group are leveraging their troves of data through advances in data science and AI to accelerate their product cycles and optimise yields.

While the opportunity across IT-exposed companies appears significant, the market is clearly aware of this and in many instances investors are pricing in a significant level of blue-sky potential. This is highlighted below in a graph that shows the enterprise value (EV)/ sales multiple for the Information Technology sector on the ASX (green), versus the NASDAQ (orange). It highlights a scarcity premium in the Australian stocks and a reason for a little caution.

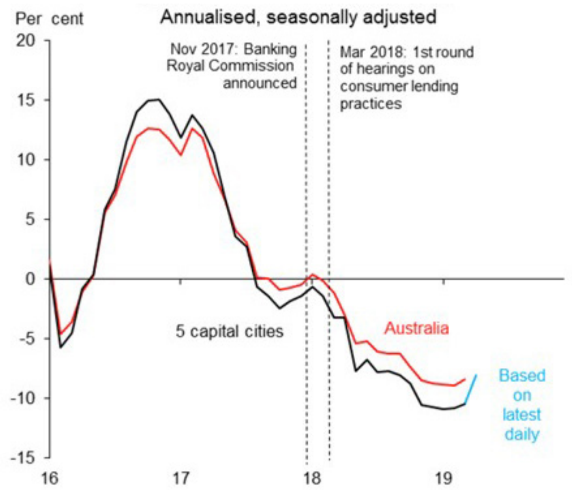
Information Technology EV/sales multiples

Source: Bloomberg

Domestic headwinds can present contrarian opportunities

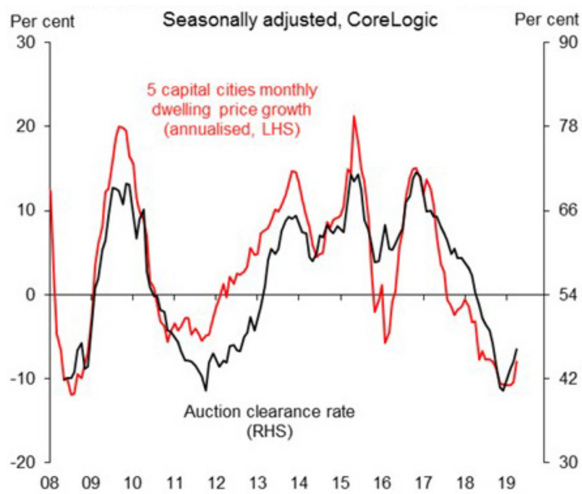
Domestic companies are clearly operating in a difficult environment at present. Inflation figures remain flat and retailers have anaemic sales growth, but rising labour costs. The pullback in housing is not helping the consumer and activity levels remain low ahead of the election. There are some tentative signs of stabilisation in housing, but we think it is too early to call the bottom.

Monthly dwelling price growth



Source: Macquarie Research

Auction clearance rates & dwelling prices



Source: Macquarie Research

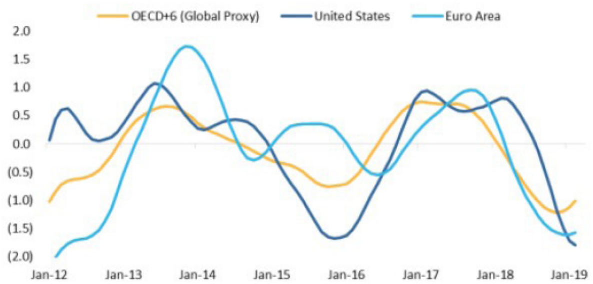
Nonetheless, this uncertainty can represent opportunities to buy good companies at attractive valuations. We have added to a range of quality companies with exposure to the domestic economy including SEEK, REA Group and Wesfarmers. SEEK and REA Group are also exposed to the digitisation trend, with SEEK presenting an interesting report at the Macquarie Australia Conference 2019. The stock has been a little soft due to market concerns regarding the slowdown in job adverts in Australia, but the report highlighted:

- Growth predictions of 16–20% in revenue in 2019 despite a soft environment for employment advertising.
- Market leadership in 18 countries and exposure to circa 2.9b people—a quarter of the world's GDP.
- An ambitious opportunity to be a $5b revenue business by FY25, 4x current revenue.
- The opportunity in Australia to grow revenue by introducing new product that leverages databases of candidates (including moves into HR and contingent labour) and by introducing premium pricing for high-value candidates. This is similar to REA Group's depth strategy that has driven a 10-fold increase in revenues.
- Introducing these products and strategies into Asia.
- A push to cement leadership in China, benefit from high GDP growth, and ultimately drive margins higher as it seeks to align pricing with value provided.
- A push into online education by supporting universities offering online courses.

Global economic recovery

Our visit to China highlighted some improving sentiment in that market as it responds to government stimulus and the potential for a resolution of the trade agreement with the US. Recent economic indicators remain quite supportive of growth in China and the US, and our portfolios continue to have a large exposure to offshore companies that are participating in these growing markets.

OECD leading indicators (6ma rate of change)

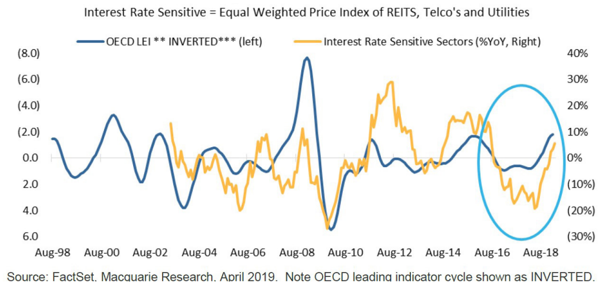


Source: FactSet, Macquarie Research

Interest rate sensitives

We remain underexposed to defensive businesses like property trusts and infrastructure assets that have benefited from both the risk-off environment during the December quarter and subsequently the low bond yields in March. We see little value in these stocks, other than as a place to hide during a period of risk-off. Should the economic cycle improve, we would see these stocks struggle.

US economic cycle vs interest rate sensitive sectors



Source: FactSet, Macquarie Research

Banks

The banking sector has delivered a disappointing reporting season with those exposed to housing and retail banking being particularly weak. Competition has intensified in a low-growth environment. Asset quality remains sound but is off its lows and uncertainty remains regarding remediation and ASIC fines. While any improvement in housing would provide some relief for the sector (which is under held by institutions), it remains difficult to see much profit growth.

National Australia Bank is our preferred bank for the following reasons:

- It is cheaper, trading at a 10–15% discount to the sector despite earning a higher ROE than ANZ Banking Group (ANZ) and Westpac Banking Corporation (WBC).
- The risk of a dividend cut has now been removed.
- Its exposure to retail banking (which is under pressure) is only 19% and this is significantly below its peers.
- Its cost-cutting program is advanced and will provide earnings growth opportunities relative to peers. In the recent half it delivered better growth than ANZ Banking Group and Westpac Banking Corporation and this appears set to continue.
- The appointment of a new CEO is likely to be a positive catalyst. The Chair is well respected and the opportunity to bring in talent to reinvigorate National Australia Bank is significant. We believe a CEO would see this as a strong opportunity. Despite its disappointments over the years, it retains a strong business and private banking franchise. A new CEO could reinvigorate the culture and performance, and this would drive a re-rating.

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Portfolio positioning

Our current positioning is as follows.

- Underweight bond proxies like A-REITs and utilities, which have already capitalised low bond yields.
- Underweight banks and domestic consumer due to high consumer debt levels.
- Overweight an increase in mining and oil and gas capex via WorleyParsons (WOR).
- Overweight a basket of quality companies with durable earnings growth—SEEK (SEK), REA Group (REA), IRESS (IRE), Breville Group (BRG), ResMed (RMD).
- Overweight stocks that offer reasonable growth at a reasonable price—Link Administration Holdings (LNK), Aurizon Holdings (AZJ), Lendlease (LLC).

Portfolio moves

Purchase of Suncorp Group (SUN)

We have added Suncorp Group to the portfolio for the following reasons:

- It is underweight defensive names (given it is restricted from holding gaming and food retailers like Tabcorp Holdings (TAH) and Woolworths Group (WOW)).
- The outlook for general insurers is brighter than that of banks, with less regulatory risk and a stronger industry structure with only two main players. Underlying revenue growth is circa 4–5% compared to 1–2% for the banks.
- It trades at a discount to its nearest peer, Insurance Australia Group (IAG).

Suncorp Group meets DNR Capital's five-point quality web:

1. Industry structure—Strong, with two main players in the market who have reputable brands.
2. Earnings strength—Return on equity and margins are improving as the cycle recovers.
3. Balance sheet—Remains sound with high asset quality and excess capital following the sale of its life business.
4. Management—We have some concerns with senior management but think the strengths of the business and middle management compensate.
5. Environmental, social and governance (ESG)—Risks from ESG factors are low having come through the banking royal commission relatively unscathed, though natural perils remain an ongoing theme for insurance businesses.

Key risks

- High frequency of catastrophe events.
- Commoditisation of motor and personal lines drives competition, market share losses.
- Quality of underlying margins—excessive reserve releases, meaningful recurring one-offs and bullish catastrophe bond budget overstating underlying margin.
- Bank asset growth benign, net interest margin under pressure and bottom of cycle credit losses.

Valuation

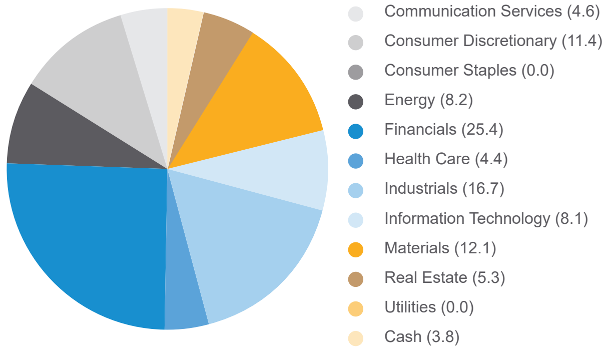
- Suncorp Group trades at a 20% premium to banks but a 20% discount to Insurance Australia Group on a price-earnings ratio basis.
- Dividend plus growth is circa 10–11% p.a. compared to 5–7% p.a. for banks and Insurance Australia Group.
- Sum of parts valuation supports a return of 16%, indicating that excess valuation exists if it is able to separate the bank business, allowing the insurance business to trade on a higher multiple, closer to the Insurance Australia Group valuation.

Conclusion

The insurance business is benefiting from a cyclical tailwind as premiums harden. This is enough to offset potential hurdles including higher regulatory costs and increasing natural perils. Internally there continues to be a lack of cohesion due to management uncertainty around strategy. Nonetheless, earnings risk looks weighted to the upside. Consensus looks 5–7% undercooked, partially due to reserve releases and perils upside which is less sustainable. As we look into FY2021, upside appears greater as there is the potential for a reduction in regulation and more cost-out to come.

Portfolio attribution

Sector weightings %



Source: DNR Capital

12 month - top contributors and detractors

Top 5 contributors		Alpha*
IPH	Overweight	2.30%
Breville Group	Overweight	1.93%
IRESS	Overweight	0.72%
Macquarie Group	Overweight	0.59%
Nanosonics	Overweight	0.54%
Top 5 detractors		
BWX	Overweight	-2.30%
Lendlease	Overweight	-1.78%
CYBG	Overweight	-1.29%
Janus Henderson Group	Overweight	-1.03%
National Australia Bank	Overweight	-0.70%

Monthly - top contributors and detractors

Top 5 contributors		Alpha*
Breville Group	Overweight	0.48%
Lendlease	Overweight	0.23%
IRESS	Overweight	0.22%
REA Group	Overweight	0.18%
South32	No Holding	0.15%
Top 5 detractors		
Westpac Banking Corporation	Underweight	-0.12%
Commonwealth Bank of Australia	Underweight	-0.11%
Rio Tinto	Overweight	-0.11%
ANZ Banking Group	No Holding	-0.10%
National Australia Bank	Overweight	-0.09%

** 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 were:

- Breville Group (BRG)—Continued its impressive run during the month after pausing for breath in March. The market is now becoming comfortable with the global growth opportunity after the successful entry into Germany and appears to be pricing in similar success in Belgium, The Netherlands, Luxembourg and potentially, Spain.
- Lendlease (LLC)—Was up this month as the market appears to be more comfortable with the state of the business and rumours of a sale of the engineering division circulate. A resolution on this front could provide a catalyst for the stock and prove up our long-term thesis of underlying value in the business.
- IRESS (IRE)—Continues to benefit from the aftermath of the banking royal commission, with financial services businesses quickly addressing their systems and compliance solutions. The expansion of the business into overseas markets like the United Kingdom also looks to be going well and represents an excellent growth opportunity.

The top stock detractors were:

- Westpac Banking Corporation (WBC)—Banks enjoyed a relief rally last month as investors consider the effects of a rate cut on the housing market. While it is supportive of credit growth, we would point out the lacklustre performance of the banks during their earnings period and suggest that many headwinds still exist.
- Commonwealth Bank of Australia (CBA)—Banks enjoyed a relief rally last month as investors consider the effects of a rate cut on the housing market. While it is supportive of credit growth, we would point out the lacklustre performance of the banks during their earnings period and suggest that many headwinds still exist.
- Rio Tinto (RIO)—1Q19 result flagged weaker production, which was broadly expected by the market given soft commodity prices. We maintain our view that Rio Tinto is the best producer in the space and would expect some weakness in commodity prices given the strong run that it has had.

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.

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.

Platform access

- AMP PPS
- BT Panorama
- Colonial First State FirstWrap
- Federation Alliance
- HUB24
- Linear
- Netwealth
- OneVue
- Powerwrap
- Praemium

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