

DNR Capital Australian Equities High Conviction

Quarterly Investment Option Update

30 September 2021

Aim and Strategy

To invest in a high conviction portfolio of Australian shares that aims to outperform the benchmark by 4% p.a. (before fees) over a rolling three-year period. DNR Capital seeks to identify good quality businesses that are mispriced by overlaying DNR Capital's quality filter with a strong valuation discipline.

DNR Capital's security selection process has a strong bottom up discipline and focuses on investing in quality businesses at reasonable prices. 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 investment strategy results in a high conviction portfolio of 15 to 30 stock names that is invested for the medium-to-long term.

Investment Option Performance

To view the latest investment performances for each product please visit amp.com.au/performance

Investment Option Overview

Investment Category	Australian Shares
Suggested Investment timeframe	5 years
Relative risk rating	7 / Very high
Investment style	Specialist - Quality
Manager style	Single Manager

Asset Allocation	Benchmark (%)	Actual (%)
Australian Shares	100	96.89%
Cash	0	3.11%

Sector Allocation	%
Communication Services	9.97%
Consumer Discretionary	13.26%
Consumer Staples	4.61%
Energy	4.23%
Financials	24.69%
Health Care	3.71%
Industrials	6.19%
Information Technology	6.92%
Materials	16.04%
Real Estate	7.28%
Utilities	0.00%
Cash	3.11%

Top Holdings	%
National Australia Bank Limited	8.23%
BHP Group Ltd	7.42%
Macquarie Group Limited	7.14%
Telstra Corporation Limited	5.13%
Tabcorp Holdings Limited	4.77%
Aristocrat Leisure Limited	4.62%
Woodside Petroleum Ltd	4.23%
Lendlease Group	4.00%
QBE Insurance Group Limited	3.81%
CSL Limited	3.71%

Portfolio Summary

Over the past quarter there have been a number of changes to the portfolio and the current positioning is as follows:

- Inflation hedges. Exposure to a number of stocks that benefit from rising inflation such as Computershare and QBE.
- Exposure to defensives with bottom up drivers were increased given the Chinese / stagflation risks.
- Quality market leaders. Quality stocks with pricing power can protect earnings during an inflationary period. Stocks such as Seek, James Hardie and Xero retain strong pricing power.
- Opening up laggards. While the cyclical recovery might slow if the supply chain constraints accelerate, the economies will continue to open which will present opportunities for those stocks which have been impacted by lockdowns.

Investment Option Commentary

Over the past quarter the team have undertaken a range of moves aimed at building further portfolio resilience. The fund has increased the quality of the portfolio, adding to areas of the market generating strong returns with improving industry structures.

Positions initiated over the quarter:

- **Endeavour Group Limited (EDV):** The liquor retailer offers long duration, and sustainable earnings growth, leveraging a dominant market share by expanding into the online and premiumisation trends. The Hotels business features more cyclical earnings exposure but offers significant upside from several years of underinvestment under Woolworths and an aging gaming machines fleet. The valuation is attractive with the market underappreciating the upside to returns and network expansion.
- **Xero Limited (XRO):** A position in Xero was reopened during the period as valuation metrics improved while leading data on business formation and churn accelerate in key markets.

Positions exited over the quarter:

- **Commonwealth Bank of Australia (CBA):** CBA is performing well relative to the other banks with strong systems and a good franchise but following strong performance it trades at a 40% price-to-earnings (PE) premium to the majors and at a large premium compared to its history and to global peers.
- **REA Group Limited (REA):** The position was sold on stretched valuation in context of peak housing turnover and rising risk of macro prudential constraints.

Market Commentary

The market edged higher in the September quarter, with the S&P/ASX 200 Accumulation Index returning 1.71% during the period. A strong run through July and August was arrested in September as fears of inflation and its impact on the economy caused markets to fall. Stretched and damaged supply chains, combined with a recovering demand profile have led to price spikes across the economy, most notably in energy. Supply destruction during the pandemic period, combined with a lack of expansionary capex in the face of environmental pressures has led to global energy shortages, threatening the strength of the economic recovery.

Energy (+7.6%) was the best performing sector during the period. The sharp spike in energy prices was broad based, with coal, oil and natural gas all surging under supply-constrained conditions. Woodside (WPL +7.5%) outperformed as the biggest weight in the sector, with coal prices driving Soul Patts (SOL +15.7%) and Whitehaven (WHC +66.5%) higher.

Industrials (+5.9%) also outperformed, with transport reopening names leading the rally. A bid for Sydney Airport (SYD +42.3%) set the tone for the sector, with strong performances also coming from Auckland Airport (AIA +11.4%) and Qantas (QAN +21.7%) as a reopening of borders towards the end of the year remains a possibility.

Materials (-13.3%) was the worst performing sector. Iron ore prices retraced significantly from their highs due to an economic slowdown in China, largely the result of tightening stimulus and increased government oversight. All of the iron ore majors were down substantially, with BHP (BHP -22.5%), Rio Tinto (RIO -20.9%) and Fortescue (FMG -35.9%) all underperforming.

Consumer Discretionary (+1.6%) also underperformed despite finishing higher. The sector was diverse in its performance, with company-specific drivers the focus. Strong returns from Dominos (DMP +33.2%) and Aristocrat (ALL +9.0%) were weighed down by retail giant Wesfarmers (WES -5.7%).

Outlook

Energy and Supply Chain Disruption

Panic buying of energy – from gas to coal to oil has accelerated as the Northern hemisphere fears being short energy over winter.

The drivers of this include:

1. Strong demand on reopening of the economies.
2. Supply constraints. A lack of investment in fossil fuels and related infrastructure as ESG and stranded asset concerns limit investment.
3. Realisation that there are no quick fixes. Once renewable reaches a certain threshold then there is a need to accompany it with LNG or nuclear to provide support at peak times. Alternatives such as hydrogen appear to be some way off practical application, and battery storage offers limited application at present.

The consequence is panic buying pushing the oil price up to US\$75 a barrel and LNG in Asia at US\$30/BTU (compared to long term expectations of \$8). These moves have supported energy companies but they have still sharply underperformed over the past year which suggests they can continue to re-rate.

Stagflation concerns

The current energy crisis raises memories of a 1970s style energy crisis. The issue with tightness in energy markets is that problems are not quickly resolved. It is difficult to envisage a strong pick up in fossil fuel projects, and nuclear power remains politically challenging. The world however is a different place to the 1970s. The US is less reliant on manufacturing and oil, and unions are not as powerful. Nonetheless, the disruption increases the risk of slowing growth, at the same time inflation pressures are building. While DNR Capital does not forecast this as a base case, the manager remains cognisant of this risk, given the strong moves in markets to date.

Availability

Product name	APIR
AMP Flexible Lifetime Super	AMP1199AU
AMP Flexible Super - Retirement account	AMP1386AU
AMP Flexible Super - Super account	AMP1515AU
CustomSuper	AMP1199AU
Flexible Lifetime - Allocated Pension	AMP1203AU
Flexible Lifetime - Term Pension	AMP1235AU
Flexible Lifetime Investment**	AMP1207AU
Flexible Lifetime Investment (Series 2)**	AMP1441AU
SignatureSuper	AMP1213AU
SignatureSuper Allocated Pension	AMP1222AU

**Closed to new and existing investors

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