DNR Capital Australian Equities High Conviction

Quarterly Investment Option Update

31-December-2017

Availability

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

Investment Option Performance

Investment performances are subject to product fees and where relevant tax as outlined in the product PDS. Therefore investment performance may differ between products. In addition, activity on your account such as contributions and deductions will also impact the investment performance specific to you. To view the latest investment performances for each product, please visit **www.amp.com.au**. You can also view the last investment performance specific to you by visiting your My Portfolio account.

Contact Us

Web: www.amp.com.au

Email: askamp@amp.com.au

Phone: 131 267 (Mon. to Fri 8:30am to 6:00pm AEST)

Overview

Aim & 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 buying 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 term.

Investment category: Australian shares – specialist

Suggested Investment Timeframe: 5 years

Standard Risk Measure: 6/ High

Asset Allocation	Actual (%)	Range (%)
Australian Equities	97.08%	95-100%
Cash	2.92%	0-5%

Holdings

Industry Exposure	%
Consumer Discretionary	5.50
Consumer Staples	9.29
Energy	2.77
Financials	29.86
Health Care	3.34
Industrials	16.55
Information Technology	9.07
Materials	15.51
Real Estate	5.18
Telecommunication Services	0.00
Utilities	0.00
Cash	2.92

Regional Exposure	%
Australia	100

Top Ten Securities	%
National Australia Bank	8.30
Commonwealth Bank of Australia	6.84
Woolworths Group	6.43
BHP Billiton	6.35
Macquarie Group	5.75
Lendlease	5.18
Brambles	4.56
Westpac Banking Corporation	4.54
Janus Henderson Group	4.43
James Hardie Industries	4.16

Market Commentary

A number of significant events in 2017 impacted financial markets. They included: the inauguration of Donald Trump as President of the United States (January); the UK activating Article 50 and commencing the European Union exit process (March); a convincing victory for President Macron in France (May); North Korea completing its sixth nuclear missile test (September); Xi Jinping being named for a second five-year term as party general secretary at China's Communist Party congress (October); and the US Senate approving sweeping tax reform (December).

While the ASX 200 is above 6,000 for the first time in a decade, Australian equities lagged global peers by ~10% in 2017. This was primarily due to weaker earnings per share (EPS) growth and a relative price earnings (PE) derating as the world PE rose, while Australia remained broadly flat. From a sector perspective, the simple reason for Australia's underperformance is that the market is heavily overweight banks and heavily underweight IT. The local bank sector struggled for EPS growth in 2017 and delivered +2% total return. Australia has close to nil weighting in IT, which was the strongest performing sector globally by a large margin (+37%). Excluding the banks, the ASX 200 tracked broadly in-line with global trends.

The market PE finished the year broadly flat at ~15.5x, above the long-term average. However, it is still within the trading range of the last few years and remains cheap compared to bonds.

Investment Option Commentary

The portfolio is positioned as follows:

- Improving quality
  - Global growth improving—Rio Tinto (ASX:RIO), ALS (ASX:ALQ), WorleyParsons (ASX:WOR)
  - Global reflation and fiscal stimulus—Janus Henderson Group (ASX:JHG), Lendlease (ASX:LLC), Macquarie Group (ASX:MQG).
- De-rated quality
  - Offshore-exposed growth—Brambles (ASX:BXB), James Hardie Industries (ASX:JHX)
  - Turnarounds—Woolworths Group (ASX:WOW), Tabcorp Holdings (ASX:TAH)
  - Ageing demographics—Healthscope (ASX:HSO).
- Sustainable growth
  - SaaS businesses—IRESS (ASX:IRE), MYOB Group (ASX:MYO)
  - Internet models—SEEK (ASX:SEK), REA Group (ASX:REA) (realestate.com.au)
  - Chinese consumer—Treasury Wine Estates (ASX:TWE)
  - Underweight bond proxies where we want to protect against a potential increase in inflation
  - Underweight consumer given the threat from Amazon and the over-leveraged consumer. We remain underweight banks (albeit this is a decision causing some angst given the potential for stronger short-term results offset by the risks of an overheated property market, leveraged consumer, cyclically low bad debts and the Royal Commission).

Underweight company valuations supported by unsustainably low interest rates.

Outlook

For global markets, expectations remain for above-average returns continuing into 2018. However in this scenario, Australia is likely to be a laggard. While Australian GDP growth is forecast to do a little better in 2018, the composition of this growth (slower consumer and slower housing) means Australia is unlikely to replicate the expectations for double-digit growth forecast in other regions. The Australian market is forecasting a ~5% EPS growth in 2018, which is slightly below average growth levels. DNR do note that there remains potential earnings upside from resources, given where spot commodity prices are.

Australia still offers pockets of value and dividend yields remain attractive. The investment manager see opportunities in the following areas:

- global growth
- diversified financials exposed to rising interest rates
- infrastructure and resource-linked companies
- inflation hedges
- internet models and software as a service (SaaS) models.

DNR remain wary of the media, retail, telecommunications and bank sectors, as they all face significant structural challenges and lack a discernible growth trajectory. Noting:

- media/broadcasting stocks are facing substantial competition from Facebook, Twitter and Netflix
- retailers await the full entry of Amazon
- the telecommunications market faces heightened competition in a post-NBN world along with other technological advances
- banks are facing an over-leveraged consumer, property headwinds, cyclically low bad debts, regulatory/political risks, as well as technological threats.