DNR Capital Australian Equities High Conviction

Quarterly Investment Option Update

30-June-2018

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.

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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	96.14%	95-100%
Cash	3.86%	0-5%

Holdings

Industry Exposure	%
Consumer Discretionary	4.59
Consumer Staples	9.48
Energy	5.35
Financials	27.09
Health Care	3.29
Industrials	14.93
Information Technology	9.19
Materials	16.55
Real Estate	5.67
Telecommunication Services	0.00
Utilities	0.00
Cash	3.86

Regional Exposure	%
Australia	100

Top Ten Securities	%
National Australia Bank	7.45
BHP Billiton	7.28
Woolworths Group	6.94
Westpac Banking Corporation	6.17
Lendlease	5.67
Macquarie Group	4.99
James Hardie Industries	4.75
Tabcorp Holdings	4.59
Brambles	4.13
Aurizon Holdings	3.64

Market Commentary

A narrow range of sectors and companies are experiencing very strong returns. The outsized returns from a range of information technology (IT), healthcare and China-exposed companies are at odds with traditional companies like Telstra, the banks and hospital groups, which have been struggling.

The growth being offered by emerging companies is significantly greater than that provided by traditional sectors. In a world awash with digital disruption, many traditional industries are struggling with legacy cost bases and systems that leave them in an uncompetitive position relative to new emerging players.

Investment Option Commentary

The valuation gap between the companies operating in technology, healthcare and those exposed to the Chinese consumer has continued to open relative to other segments over the past year. This situation creates obvious questions. Are these multiples justifiable, and what will cause markets to alter the current positioning?

We are concerned that these trades are becoming crowded and believe some caution is warranted. We see a number of warning signs—aggressive valuation assumptions using low risk-free rates, use of new valuation techniques like price to sales to justify valuations, and heavy use of vague addressable market assumptions to increase the terminal value of these companies.

Given these warning signs, we consider potential factors that could cause the market to reassess valuations of these stocks:

- As growth-stock multiples extend, confidence increases and the market lifts earnings expectations to help justify valuations. This sets up some of these stocks for future disappointment. The downside for stocks on high multiples that disappoint can be savage.
- We have been discussing for some time the potential for inflation to rise in response to a changing political climate. Inflation is rising in the US and lifting risk-free rates. Given much of the value in growth stocks is reflected in the terminal value, a change in risk-free rates can have a significant impact on the valuation. A spike in inflation could negatively impact these stocks.

However, a key component to the outperformance has been a lack of viable alternative investments. As traditional stocks underperform, they have been forced to address their businesses. In recent years we have seen Woolworths Group (ASX:WOW) reset its margins to ensure it was competitive, Coca-Cola Amatil (ASX:CCL) is reducing sugar content and reinvigorating its water offering and Telstra Corporation (ASX:TLS) is reducing the number of plans on offer and cutting costs. We expect the banks to move to an aggressive cost out phase and many of these traditional players are investing heavily in technology to improve their competitive position. While some players will remain at a significant competitive disadvantage, opportunities are emerging to buy companies that have rebased earnings and are at low valuations. The more companies that meet these criteria, the more alternatives will be presented to the market.

So, opportunities will be presented outside of some of the crowded trades in the market, but we caution and reiterate:

- In an era of rapid technology change value traps are prevalent, so we need to avoid companies at risk of further disruption.
- Some growth stocks continue to justify their valuations given their earnings growth, and so we ‘do not seek to throw the baby out with the bath water’ by exiting companies where we have a good line of sight in terms of the earnings outlook. The important factor is to retain valuation discipline.

Outlook

The economic outlook appears reasonably robust. Valuations though look full in certain segments such as mid cap growth stocks and bond proxies. The overwhelming issue though is the effect that the improving economic environment combined with expansionary fiscal policies will have on inflation in the next year. A pick-up in inflation will likely cause some reassessment if valuations and as a consequence we are inclined to focus on companies offering valuation support at present.