YARRA CAPITAL MANAGEMENT

Investment Commentary
Month to 31 May 2021

Yarra Australian Equities Fund

Gross returns as at 31 May 2021

	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Australian Equities Fund	2.48	9.42	33.14	7.61	8.40	8.81	10.77
S&P/ASX 200 Accumulation Index†	2.34	8.48	28.23	9.94	10.11	8.81	9.48
Excess return (before fees)‡	0.14	0.94	4.91	-2.33	-1.71	0.00	1.29

Past performance is not a reliable indicator of future performance. Taxes payable by investors have not been taken into account. The figures shown have been provided for illustrative purposes – they are unaudited and subject to change. The total returns shown are gross of all fees, meaning they do not reflect the deduction of any investment management fees which would reduce returns and assume reinvestment of all distributions. Investment in the fund is not available on a fee free basis and this should be factored into any analysis of past performance.

Net returns as at 31 May 2021

	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Australian Equities Fund	2.40	9.17	31.96	6.62	7.40	7.80	9.77
S&P/ASX 200 Accumulation Index†	2.34	8.48	28.23	9.94	10.11	8.81	9.48
Excess return (after fees)‡	0.06	0.69	3.72	-3.32	-2.71	-1.02	0.29

Past performance is not a reliable indicator of future performance. Taxes payable by investors have not been taken into account. The figures shown have been provided for illustrative purposes – they are unaudited and subject to change. The total returns shown are prepared on an exit to exit basis – they include all ongoing fees and expenses and assume reinvestment of all distributions.

* Inception date Yarra Australian Equities Fund: July 1996

† The benchmark for the Yarra Australian Equities Fund has been amended since the Fund's inception. Effective 28 February 2008 the benchmark is the S&P/ASX 200 Accumulation Index, replacing the S&P/ASX 200 ex Property Accumulation Index Monthly. Further information on changes to the Fund's benchmark is available upon request.

‡ Excess return: The difference between the portfolio's return and the benchmark return.

Market review

Australian equities rose in May as Financials and Consumer Discretionary stocks more than offset weakness across Utilities and Information Technology.

The S&P/ASX 200 Accumulation Index rose 2.3% during the month, taking its 12-month return to 28.2%. The benchmark outperformed overseas Indices (with the S&P500 returning 0.7%), supported by the major banks on the back of the federal government's big spending federal budget – with $96bn of stimulus announced over 5 years – and Australia's strengthening housing market.

Within Banking (+7.3%), the Commonwealth Bank (CBA, +12.0%) and Westpac Bank (WBC, +8.2%) delivered better-than-expected updates. CBA's 3Q21 update revealed revenue growth, slightly higher net interest margins (NIMs) and significantly lower than expected bad and doubtful debts. WBC announced 1H21 cash NPAT of $3.537mn, 9% ahead of consensus, and announced an ambitious cost-out program.

Elsewhere, Consumer Discretionary (+3.5%) was led by Aristocrat Leisure (ALL, +10.8%) as its 1H21 results highlighted its leverage to the re-opening US economy and strong competitive position. Other top performers included Crown Resorts (CWN, +5.4%) and JB Hi-FI (JBH, +4.9%).

Conversely, Utilities (-6.6%) weighed on the benchmark due to AGL Energy (AGL, -9.1%) and APA Group (APA, -8.0%). The former declined amid ongoing lower wholesale electricity prices, while the latter underperformed despite reiterating FY21 EBITDA guidance and outlining its growth outlook at its Investor Day, including by shifting the business to renewables and transmission.

Within Information Technology (-9.9%), Afterpay (APT, -21.1%) underperformed over concerns its momentum was slowing across key markets as competition increased, while Xero (XRO, -6.3%) delivered a disappointing FY21 result.

Portfolio review

Key Contributors

Afterpay (APT, underweight) – the payment solutions company underperformed during the period amid concerns that momentum was slowing across its key markets, with growth in its app downloads moderating, and increasing competition in the BNPL market from large rivals such as PayPal. Our negative view of APT is premised on several factors, including heightened regulation (e.g. expense verification), increased competition and the sustainability of the company's attractive margins. We also believe the capital intensity of APT's growth is unappreciated, with its current model able to function only as EV/Sales (currently at 18.2 times on a 12-month forward basis) remains high.

Aristocrat Leisure (ALL, overweight) – the gaming company outperformed as its 1H21 results highlighted its leverage to the re-opening US economy and strong competitive position. Normalised profit after tax and before amortisation of acquired intangibles (NPATA) grew 12% y/y to $411.6mn, beating consensus by 42% and rising to just 2.5% below pre-COVID-19 levels. While earnings were strong across the board, Digital (45% of group EBIT) was the standout as social casino and social casual growth experienced a step change in growth from COVID. Our thesis remains premised on ALL's strong growth profile following the resolution of the COVID-19 crisis. ALL has a dominant position in land based games (65% of EBIT) and is set to benefit from significant opportunities from Digital (35% of EBIT), which offers a wide range of outcomes. Lastly, the stock screens as undervalued at 26.9 times forward earnings when considering the Industrials Ex-Financials trades at 28.0 times and ALL's superior long-term growth potential.

Westpac Bank (WBC, overweight) – the bank outperformed after delivering a strong 1H21 result and announcing an ambitious cost-out program. Cash NPAT came in at $3.537mn for the period, 9% ahead of consensus, driven by lower impairments and better margins. The cost-out program was the main surprise though, with management targeting a cost base of $8bn by FY24 compared to $10.2bn in FY20. Management plans on achieving savings three ways: exiting non-core businesses (which currently account for $750mn of the cost base), digitising and streamlining for customers and, lastly, simplifying the organisational structure and head office. We remain overweight the bank. While we see the cost base target as challenging (given embedded inflation), we expect that achieving even half of it will be a reasonable outcome. More broadly, our overweight position remains premised on a better-than-expected earnings and dividend recovery post-COVID. We expect bad debt expenses to be close to zero over the next 18 months, net of provision releases, driving double-digit earnings upside and capital management initiatives from FY22. WBC trades at 14.8 times forward earnings with a 4.6% dividend yield, well below peer Commonwealth Bank (CBA) at 19.5 times.

Key Detractors

Incitec Pivot (IPL, overweight) – the explosives and fertiliser maker underperformed during the period as ongoing operational issues and a soft 1H21 result overshadowed stronger fertiliser prices. Management reported EBIT of $110mn for the period – 35% below consensus forecasts – as unplanned manufacturing outages, import constraints and flooding caused lower volumes, outweighing the benefit from higher commodity prices. Notwithstanding the disappointing operational issues, we remain overweight the company as we believe the risk is skewed to the upside at current levels (at 14.2 times forward earnings). Lead indicators suggest higher demand for key commodities (urea and DAP) will sustain current spot prices, resulting in consensus upgrades. Meanwhile, the explosives business is experiencing more stable pricing as mining demand normalises in North America.

APA Group (APA, overweight) – the gas pipeline operator underperformed during the period without any negative company-specific news. At its Investor Day during the period, management reiterated FY21 EBITDA guidance (to be replaced by dividend guidance from FY22) and its strategy to shift the business towards renewables and transmission as Australia's energy mix transitions. Our positive view remains premised on our view that APA's valuation – at an EV/EBITDA of 11.9 times and with a 5.7% forecast dividend yield – is attractive when considering its exposure to increasingly important gas markets and dominant market share position. We view APA's balance sheet as very strong with $2bn of liquidity and no refinancing requirements until FY22, particularly considering that the COVID-19 crisis has had minimal impact on earnings. In the medium term, we see dividend upside given the company's relatively high funding costs and conservative balance sheet position.

CSL (CSL, underweight) – the biotechnology company outperformed as it was seen as a beneficiary of the re-opening US economy, with foot traffic at its collection centres increasing in recent weeks. We remain underweight CSL based on its forward valuation (44.2 times P/E and 29.7 times EV/EBITDA on a 12-month forward basis), which we believe appropriately captures the earnings outlook at this time. The growth outlook for CSL's key plasma products remains robust, with the company continuing to strengthen its relative market position through long-term investment in capacity, product innovation and collection centres.

Key Purchases

ResMed (RMD) – we increased our position in the company during the period, taking advantage of recent underperformance. We continue to believe RMD's core sleep apnea division will rebound strongly on the grounds that demand for its products has been deferred, not lost. Our long-term investment thesis remains intact, with benefits accruing from a positive product cycle in the flow generator and mask segments and a supportive pricing environment (post competitive bidding in the US). New software and integration with the customer is supporting device sales versus competitors. We continue to see RMD's valuation as attractive on a relative basis, trading at 37.4 times forward P/E versus CSL (CSL) at 44.2 times.

IGO Limited (IGO) – we increased our position in the lithium-nickel miner during the period. Our thesis is premised on the miner's recent $US1.4bn Greenbushes acquisition and its existing portfolio of high-quality assets. We support the acquisition for several reasons. Not only does it give IGO exposure to a high-quality, long-dated asset (>20 years mine life), but it also completes IGO's suite of battery commodities with the company already producing nickel, copper and cobalt. We also think the purchase price was reasonable, with Greenbushes likely to be NPV and EPS accretive earlier than FY23. We also hold a positive view of IGO's Nova asset – a world-class reserve which supports an increasing production profile.

Telstra (TLS) – we increased our position in the telco during the period. Our investment thesis is premised on several factors. Firstly, we believe management's guidance for Mobile growth in 2H21 and FY22 is achievable. Average revenue per user (ARPU) is set to benefit from the $5 increase across the company's back-book in November and December, its front book is seeing $3 rises from new plans and headwinds to the business relating to COVID-19, out-of-bundle plans and accounting changes are fading. Secondly, the company's cost reduction initiatives are proving to be real and flowing through to earnings, with management announcing a further $200mn to its $2bn productivity program by FY22 and reiterating "hundreds of millions" beyond that. Thirdly, TLS is committed to maintaining the current dividend (as evidenced by paying 125% of underlying earnings in 1H21), which was justified given its strong cash flow (the dividend was only 60% of FCF) and outlook for earnings growth. Lastly, we expect the sale of the mobile tower business, TowerCo, will result in a significant portion of its capital (at a $4-5bn valuation) to be returned to shareholders. We do not believe these positive factors are reflected in TLS's valuation, with the stock trading at 23.3 times 12-month forward earnings and offering a 4.6% dividend yield.

Key Sales

Vocus Group (VOC) – we exited our position in the telco during the period based on limited upside potential, using the funds to establish more compelling opportunities elsewhere. VOC trades at only a small discount to the recently announced takeover offer at $5.50 per share from a consortium comprising Macquarie Infrastructure and Real Assets (MIRA) and Aware Super. We expect the takeover to be finalised in June following shareholder approval.

Deterra Royalties (DRR) – we exited our position in the iron ore royalties company during the period, following recent outperformance. We continue to hold a positive view of DRR's Mining Area C (MAC) royalty, which entitles the company to receive 1.232% of iron ore revenue generated from BHP Group (BHP)'s Mining Area C mine and, in addition, an annual capacity payment of $1mn for every million tonne increase in exports from the area. However, we believe iron ore's recent strength – rising to almost $US200 per tonne – is unsustainable into the medium term. In this context, we do not see DRR's headline valuation (at a 12-month forward EV/EBITDA of 12.5 times) as attractive. Within Metals & Mining we prefer Iluka Resources (ILU) and IGO Limited (IGO), which offer exposure to commodities with more attractive long-term fundamentals.

Bluescope Steel (BSL) – we reduced our position in the steel producer during the period following recent outperformance. In our view the current favourable conditions are unsustainable in the medium term, with steel prices likely to revert and housing volumes likely to normalise. That being said, we retain a small overweight position based on our view BSL is a high-quality cyclical company with attractive assets (both domestically and internationally) and a strong balance sheet.

Key Active Overweights

ANZ Bank (ANZ) – we are overweight ANZ on the grounds that the bank is positioned strongly for an earnings and dividend recovery post-COVID, with capital management initiatives likely as bad debts turn out to be more benign than feared. While there are challenges to its outlook – including persistent top-line pressures from lower interest rates – the bank is able to offset these pressures by cutting costs at a superior rate to peers, and management remains committed to its $8bn expense target (requiring a $600mn cost reduction ex-investment). We see ANZ's valuation as attractive at 13.4 times forward earnings, particularly relative to NAB and CBA (at 14.1 and 19.5 times respectively).

Aristocrat Leisure (ALL) – our investment thesis is premised on ALL's strong growth profile following the resolution of the COVID-19 crisis. ALL has a dominant position in land based games (65% of EBIT) and is set to benefit from significant opportunities from Digital (35% of EBIT), which offers a wide range of outcomes. Lastly, the stock screens as undervalued at 26.9 times forward earnings when considering the Industrials Ex-Financials trades at 28.0 times and ALL's superior long-term growth potential.

Westpac Bank (WBC) – our overweight position in WBC is premised on a better-than-expected earnings and dividend recovery post-COVID. We expect bad debt expenses to be close to zero over the next 18 months net of provision releases, driving double-digit earnings upside and capital management initiatives from FY22. While we see WBC's recently announced cost base target of $8bn by FY24 as challenging (given embedded inflation), we expect that achieving even half of it will be a reasonable outcome. WBC trades at 14.8 times forward earnings with a 4.6% dividend yield, well below peer Commonwealth Bank (CBA) at 19.5 times.

Key Active Underweights

CSL (CSL) – we remain underweight CSL based on its forward valuation (44.2 times P/E and 29.7 times EV/EBITDA on a 12-month forward basis), which we believe appropriately captures the earnings outlook at this time. The growth outlook for CSL's key plasma products remains robust, with the company continuing to strengthen its relative market position through long-term investment in capacity, product innovation and collection centres.

National Australia Bank (NAB) – we remain underweight the bank. While NAB has strengthened its capital position through a highly dilutive, discounted $3.5bn capital raising and has increased collective provisioning, the bank is yet to take an AUSTRAC provision unlike its peers. Notwithstanding the improving trends for the bank, we see less scope for surplus capital compared to Westpac Bank (WBC) and ANZ Bank (ANZ). Further, both WBC and ANZ trade at more appealing valuations when considering their superior outlook and are our preferred banking exposures at this time.

Wesfarmers (WES) – our underweight position remains premised on the view its divisions, outside Bunnings (62% of operating income), face significant earnings headwinds. Officeworks (5% of operating income) and the department store industry (including discount department stores Target and Kmart, 25% of EBIT) face increasing competition and excess physical store capacity. Furthermore, the company's Industrials segment (9% of EBIT) comprises cyclical, lower quality businesses. As such, we don't find the valuation attractive at 26.4 times forward earnings.

Market outlook

The recovery in the Australian economy continues to exceed consensus expectations. The Australian economy contracted 2.5% in calendar 2020, however strong sequential growth in 2H2020 and positive momentum in early 2021 will see economic activity in 1Q2021 exceed pre-COVID levels.

The strength of the economic recovery is particularly evident via record levels for business conditions, business confidence and the strength in employment growth. The level of employment already exceeds pre-COVID levels, and after peaking at 7.5% in July 2020 the unemployment rate has declined sharply to 5.6% in March 2021.

Although wage rates remain subdued, the recovery in labour market income has been sufficient to offset the gradual withdrawal of temporary fiscal support. Moreover, the accumulation of $125bn in excess household saving, in concert with strong asset price gains, leaves the consumer uniquely positioned to underpin economic growth in 2021-2022. Dwelling investment is set to provide solid support for economic growth over the next 18 months following a surge in demand for new housing construction, partly in response to the Government's Homebuilder subsidy. We expect the global economy to expand 6.5% and the Australian economy to expand 6% in 2021.

We continue to expect US inflation to surprise on the upside over the remainder of 2021 and for policy makers to resist pressure to normalise interest rates. This may see bond yields continue to rise at a moderate rate in coming months, however, we are cognisant that global business surveys will likely peak around mid-2021 which may limit the adjustment in bond yields, at least until the Federal Reserve signals it is preparing to taper its asset purchases. We do not expect this to happen until late 2021 at the earliest.

The A$/US$ should continue to be well supported by global reflationary forces, including robust commodity price trends. We continue to expect the A$/US$ to appreciate to the 81-83c range by the end of calendar 2021.

We are most overweight stocks within the Telecommunication Services, Media & Entertainment and Consumer Services sectors, and are underweight Real Estate, Consumer Staples and Financials.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	11.95	4.12	7.83
Consumer Discretionary	10.36	8.00	2.36
Consumer Staples	1.40	5.01	-3.61
Energy	4.91	3.31	1.60
Financials	28.02	30.73	-2.71
Health Care	8.51	10.13	-1.62
Industrials	4.48	6.67	-2.19
Information Technology	4.47	3.74	0.73
Materials	19.40	20.55	-1.15
Real Estate	2.83	6.59	-3.76
Utilities	2.58	1.15	1.44

Top 5 holdings

	Portfolio %	Benchmark %	Active %
BHP	9.99	7.02	2.96
Westpac Banking	8.05	4.83	3.22
ANZ Banking	7.98	4.07	3.91
Commonwealth Bank of Australia	7.95	8.81	-0.86
Aristocrat Leisure	4.71	1.31	3.41

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
ANZ Banking	7.98	4.07	3.91
Aristocrat Leisure	4.71	1.31	3.41
Westpac Banking	8.05	4.83	3.22
Underweights			
CSL	1.92	6.58	-4.66
National Australia Bank	0.00	4.43	-4.43
Wesfarmers	0.00	3.13	-3.13

Portfolio holdings may not be representative of current or future investments. The securities discussed may not represent all of the portfolio's holdings and may represent only a small percentage of the strategy's portfolio holdings. Future portfolio holdings may not be profitable.

Income and growth

	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.
Growth return	17.14	-4.89	-1.15	-0.63
Distribution return	14.81	11.51	8.54	8.42

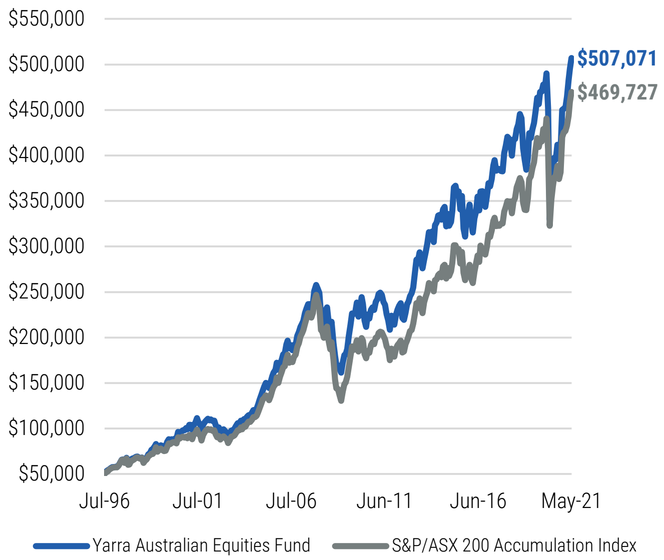
The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders by way of income distribution in a 12-month period. It does not include capital distributions.

Features

Investment objective	To achieve medium-to-long term capital growth through exposure to companies listed on the Australian Securities Exchange. In doing so, the aim is to outperform the S&P/ASX 200 Accumulation Index over rolling 3-year periods.	
Recommended investment time frame	5 - 7 + years	
Fund inception	July 1996	
Fund size	A$121.8 mn as at 31 May 2021	
APIR codes	JBW0009AU	
Estimated management cost	0.90% p.a.	
Buy/sell spread	+/- 0.15%	
Platform availability	AMP Flexible Lifetime AMP PortfolioCare AMP Wealthview ANZ Grow Wrap Asgard BT Panorama BT Wrap Colonial FirstWrap Freedom of Choice Hub24 IOOF Pursuit Select	Macquarie Wrap Accumulator Macquarie Wrap Consolidator Netwealth North Oasis OnePath PortfolioOne PowerWrap SmartWrap Wealthtrac

Investment performance comparison of $50,000

After fees, since inception of the Yarra Australian Equities Fund, July 1996 to May 2021.



For illustrative purposes only. Past performance does not guarantee future results, which may vary. The total net fund returns shown are prepared on an exit to exit basis (i.e. they include all ongoing fees and expenses and assume reinvestment of all distributions). They do not take personal taxation into account. The comparison with the S&P/ASX 200 Accumulation Index is for comparative purposes only. Index returns do not allow for transactional, management, operational or tax costs. An index is not managed and investors cannot invest directly in an index. Note that the minimum initial investment amount for the Yarra Australian Equities Fund is $10,000.

Applications and contacts

Investment into the Yarra Australian Equities Fund can be made by Australian and New Zealand resident investors only.

Website www.yarracm.com

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