YARRA CAPITAL MANAGEMENT



# Yarra Ex-20 Australian Equities Fund

## Gross returns as at 31 July 2023

| | From 25 June 2018^ | 1 month % | 3 months % | 1 year % | 3 years % p.a. | 5 years % p.a. | 10 years % p.a. | Since inception % p.a.* |
|---|---|---|---|---|---|---|---|---|
| Yarra Ex-20 Australian Equities Fund | 6.35 | 2.26 | 1.95 | 18.59 | 13.65 | 6.38 | 8.16 | 8.09 |
| S&P/ASX 300 ex S&P/ASX 20 Accumulation Index# | 6.32 | 3.40 | 2.73 | 10.00 | 10.12 | 6.41 | N/A | N/A |
| Excess return (before fees)‡ | 0.03 | -1.15 | -0.78 | 8.59 | 3.53 | -0.02 | N/A | N/A |

**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 July 2023

| | From 25 June 2018^ | 1 month % | 3 months % | 1 year % | 3 years % p.a. | 5 years % p.a. | 10 years % p.a. | Since inception % p.a.* |
|---|---|---|---|---|---|---|---|---|
| Yarra Ex-20 Australian Equities Fund | 5.39 | 2.18 | 1.72 | 17.53 | 12.64 | 5.42 | 6.98 | 6.87 |
| S&P/ASX 300 ex S&P/ASX 20 Accumulation Index# | 6.32 | 3.40 | 2.73 | 10.00 | 10.12 | 6.41 | N/A | N/A |
| Excess return (after fees)‡ | -0.94 | -1.22 | -1.01 | 7.53 | 2.51 | -0.99 | N/A | N/A |

**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.

^ **Effective 25 June 2018 the Fund's investment strategy, name and benchmark was changed. Performance prior to 25 July 2018 is provided here for consistency purposes only – the historical performance data shown relates to the previous strategy and should not be used to assess past or future performance of the Fund. Performance data relating to the previous strategy is available upon request. 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 Ex-20 Australian Equities Fund: August 2010.

# The benchmark for the Yarra Ex-20 Australian Equities Fund has been amended since the Fund's inception. Effective 25 July 2018, the benchmark is the S&P/ASX 300 ex S&P/ASX 20 Accumulation Index, replacing the S&P/ASX 300 Accumulation Index.

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

### Market review

The S&P/ASX 300 Ex-20 Accumulation Index returned +3.4% for the month, taking its 12-month return to +10.0%. In comparison, the broader S&P/ASX 300 Accumulation Index gained +2.9% and, globally, the MSCI World Index returned +3.4%.

All sectors delivered positive returns for the month, with Communication Services (+7.6%) being the top-performing sector. The Interactive Media & Services subsector was a major contributor, largely driven by the strong performance of Seek (SEK, +14.6%) and REA Group (REA, +10.1%).

Just behind, the Consumer Discretionary (+7.0%) sector also delivered a solid gain for the period. The Hotels Restaurants & Leisure sub-sector was a standout, as the share price of Flight Centre (FLT, +22.7%) soared following an earnings guidance upgrade while IDP Education (IEL, +12.6%) rebounded after a series of weaker months following concerns over increased level of competition.

The largest lagging sector for the month was Materials (+0.8%), with higher volatility observed during the period across the sector. Positive contributions from the Construction Materials (+8.1%) & Gold (+2.0%) sub-sectors were mostly offset by Diversified Metals & Mining (-4.9%). Notable stocks across the Materials sector were James Hardie (JHX, +9.4%), Evolution Mining (EVN, +14.9%), IGO (IGO, -9.2%) and Allkem (AKE, -7.5%).

### Portfolio review

**Key Contributors**

United Malt (UMG, overweight) – the global commercial malt processor and distributor outperformed as Malteries Soufflet signed a binding deal to acquire UMG at $5.00 a share (a +45% premium to the undisturbed price) following an extensive period of due diligence.

Worley (WOR, overweight) – the leading provider of global engineering services outperformed during the month as the share price reached its highest level since 2020. We attribute this outperformance to the increasing market awareness of the margin expansion opportunity that the company detailed at its recent investor day. We remain attracted to WOR, and expect strong revenue growth and margin acceleration over the coming years as the company benefits from a more consolidated industry structure, operating leverage, and active mix management.z

Tyro Payments (TYR, overweight) – the payments terminal provider outperformed during the month following the exit of strategic holder Grok Ventures from the register. Grok's 12.4% shareholding had been an overhang on TYR's share price and the stock rallied post the selldown transaction.

**Key Detractors**

Iluka (ILU, overweight) – our overweight position in the mineral sands company was a detractor during the month. Despite the company's solid June quarterly production report, ILU expects demand to be softer during 2H23. Competitor Tronox also highlighted this trend which led to market concerns. While we see short-term demand risks, traditional supply sources – particularly in South Africa – appear to be in decline, supporting ILU's expectations for flat pricing in the second half. We continue to favour the mineral sands markets for long-term investment, and specifically ILU as the world's largest Zircon producer and fifth largest producer of titanium feedstocks. Iluka is moving into Rare Earths production through its Eneabba refinery, adding potential for the company to become a critical component producer for the EV industry.

Tabcorp (TAH, overweight) – the wagering operator underperformed in the lead up to its August result, led by concerns that market turnover has remained soft (likely down 5-10% in 2H23). We continue to see an opportunity over the medium term, and view TAH as a net beneficiary of the upcoming Victorian wagering license tender and regulatory alignment between retail and digital operators. In our view, the company also remains well positioned to benefit from its refreshed TAB25 strategy and gradual consolidation in the sector, which we expect will assist in delivering on the company's medium-term 10% ROIC target.

Link Group (LNK, overweight) – the administration services provider underperformed during the month following the announcement of a major contract loss in late June in its Retirement & Superannuation Solutions (RSS) business. Whilst the revenue and earnings loss from this specific contract – which will roll off in FY25 – is manageable (approximately 4% of group revenue and 6% group EBIT), the loss in confidence around LNK's ongoing major client renewal cycle has seen the stock de-rate further.

**Key Purchases**

Stockland (SGP) – we initiated a position in Australia's largest residential land developer based on a view of the company's capacity to benefit following a peaking of interest rates, quality land assets in key growth corridors across Australia and well-funded financial position. The valuation is supportive, with the stock offering a 6% dividend yield and trading below net asset backing.

Vicinity Centre (VCX) – we increased our position in the shopping mall owning REIT in the period. Key supportive factors include VCX's retail asset mix, with over half its asset base exposed to more advantaged segments of bricks & mortar retailing (i.e. luxury, DFO outlets and recovering CBDs), more resilient in-place leases with high occupancy and fewer holdovers. Additionally, VCX has a strong balance sheet (gearing 25.7% as at Dec-2022) and attractive valuation, with the stock trading at 0.80-times net asset backing and offering a dividend yield above 6%.

JB Hi-Fi (JBH) – we increased our position in the retailer over the period, reflecting our confidence that JBH will continue taking market share to offset the broader weakness in consumer electronics and home appliances. We view JBH as a best-in-class operator that is well positioned to navigate the volatility ahead despite a softening consumer environment, with strong cash generation and a robust balance sheet. Unlike its peers, consensus earnings also already reflect a -26% EPS correction in FY24, resulting in JBH trading at an historical discount which we believe is unwarranted (13.4 times P/E vs. 14.3 times long-term average).

**Key Sales**

United Malt (UMG) – we exited our position in the global commercial malt processor and distributor after it signed a binding offer with Malteries Soufflet to acquire UMG at $5.00 a share (a +45% premium to the undisturbed price) following an extensive period of due diligence. With UMG trading close to deal terms, we see limited potential for further outperformance.

Iluka (ILU)– we trimmed a small portion of our position in the mineral sands producer during the period on expectations of a soft 2H23. While the company's June quarterly production report was solid, the company expects some softness in demand during the second half of 2023. Competitor Tronox also highlighted this trend, leading to market concerns. While we see short-term demand risks, traditional supply sources – particularly in South Africa – appear to be in decline, supporting ILU's expectations for flat pricing in the second half. We continue to favour the mineral sands markets for long-term investment, and specifically ILU as the world's largest Zircon producer and fifth largest producer of titanium feedstocks. Iluka is moving into Rare Earths production through its Eneabba refinery, adding potential for the company to become a critical component producer for the EV industry.

QBE Insurance (QBE) – we trimmed our position in the global general insurer following a recent period of outperformance, but remain overweight. QBE released a trading update ahead of its full year result, pre-empting concerns on catastrophe (CAT) allowances following storm events in the United States towards the end of half that have impacted peer results. While 2023 will again be impacted by elevated CAT claims, the update highlighted ongoing strength in the underlying business including strong GWP growth and underlying combined ratio expansion.

**Key Active Overweights**

Reliance Worldwide (RWC) – we view the plumbing supplies company as a compelling opportunity, with the market pricing a significant decline in earnings (P/E of only 14.8 times vs 17.0 times mid cycle) whereas we remain constructive on the through-cycle demand environment given the defensive nature of RWC's revenue base, the majority of which relates to more non-discretionary, repair type housing activity.

Worley (WOR) – we remain overweight the leading provider of global engineering services. WOR's earnings recovery is in its early stages following COVID-19 impacts across FY20-22. Revenue is expected to grow 13-15% in FY23, with leading indicators (Factored Sales Pipeline +36%, Rolling 12 Month Bookings +28%, Backlog +8%) and structural drivers (capital investment required to decarbonise) pointing to strong top-line growth ahead. Margins are also set to accelerate over the coming years as WOR benefits from a more consolidated industry structure, operating leverage, and active mix management.

Carsales.com (CAR) – we remain overweight the online car classifieds company based on improving yields from products such as Instant Offer and Select in Australia (~50% of CAR valuation). CAR's US business, Trader Interactive (~30% CAR valuation) also has a positive outlook, with strong potential from various drivers (an uplift in dealer penetration, moving from a subscription based to a leads-based and higher yielding model, and an improvement in inventories on the site). CAR trades on 29.0 times FY24 earnings, which we view as relatively undemanding given the tailwinds from these various drivers.

**Key Active Underweights**

Brambles (BXB) – we remain underweight the global provider of pallet pooling solutions to various FMCG producers. Brambles currently has strong momentum (16% underlying profit growth in 1H23), with expectations for 17-19% growth over FY23 and improving free cashflow. We remain cautious, however, on the sustainability of the current high level of profit and believe the market is already factoring in improving free cash flow at current levels.

James Hardie (JHX) – we retain an underweight position in the leading building materials supply company. Notwithstanding a number of quality aspects to JHX's business (i.e. market share growth, a responsive operational and manufacturing footprint) we remain cautious on the ongoing strength in end markets for JHX (a portion of discretionary renovation spend, often labelled as remodelling activity). These factors are suggestive of future earnings vulnerability, making it difficult to support the stock at current valuation of 20.9 times forward P/E. Our preferred building material company remains Reliance Worldwide (RWC), which trades on 14.2 times forward earnings.

Suncorp (SUN) – we remain underweight Australia's second largest insurer and regional bank Suncorp, with a preference for peers Insurance Australia Group (IAG) and QBE Insurance (QBE) for insurance exposure, while we retain an underweight sector view on Australian banks. Despite maintaining a positive outlook for domestic general insurance, which will benefit SUN, the previously assumed sale benefits from the deal to sell SUN's bank to ANZ are now unlikely to ensue following the ACCC's rejection of the proposed buyout.

## Market outlook

With the major central banks declaring that further interest rates are now data dependent and as evidence continues to accumulate that inflation continues to moderate, our long-held view that mid-2023 would mark the top of the interest rate cycle appears to be broadly on track. Crucially, both labour markets and core services inflation have eased in recent months and forward indicators suggest further progress should be made through the rest of 2023.

As a consequence, interest rate futures have been quick to price 125 bps of easing in the US through 2024, albeit interest rate futures in most other major economies have merely removed multiple rate hike expectations and adopted a flatter profile through 2024 around current levels rather than actively embedding interest rate reductions.

Moreover, the pessimistic tone of the economic activity data in the US that threatened a technical recession has given way to slightly more update data in recent weeks encouraging the belief that the US will escape a technical recession in 2023. Indeed, some leading indicators are suggesting that a broader turn in the global industrial cycle is at hand, which should encourage a rotation from a narrow mega-cap tech led equity market rally to broader participation in 2023.

While negative EPS revisions are likely to persist for several more months, a levelling out in economic momentum and an end to the interest rate tightening cycle will likely provide a shift from bearish equity positioning. Rising bond yields continue to provide the more significant challenge to equity market valuations, albeit the lift in bond yields into mid-2023 can mostly be attributed to a significant lift in the supply of US bonds as the US budget deficit continues to increase sharply, thereby providing a counter cyclical boost to economic growth.

Economic growth has also slowed in Australia, recording just 0.3% q/q growth in the March quarter, with much of this growth able to be traced merely to strong population growth and ongoing engineering construction projects. It is clear the prior tightening of monetary policy is having a material impact on the interest rate sensitive parts of the economy. Nominal retail sales have slowed to 0% (six-month annualised), following on from declining volumes in recent quarters. Building approvals continue to decline and are likely to fall further in coming months as declining housing affordability outweighs the impact of an under supplied housing market. Moreover, it is also clear that despite the Federal Budget forecast to return to surplus, government demand growth is waning even faster than private demand growth.

Nevertheless, the good news is that after a pause in the tightening cycle in July, The Reserve Bank of Australia (RBA) remained on hold in August and flagged that future monetary policy adjustments will be data dependent. To be clear, the RBA retains a tightening bias, however an update of their inflation forecasts now has inflation returning to inside the target band in 2025, providing a signal that absent any unexpected inflation shocks the RBA's rate tightening cycle is complete. The RBA also revised down economic growth modestly to just 1.0% in 2023, acknowledging that local economic growth had faltered.

Australia should still be able to avoid a technical recession due to four key reasons:

1. Australia has been a net beneficiary of global commodity shortages and the prior surge in commodity prices. Commodity prices are now off their peaks, and although they remain very elevated from a historical perspective, the impact of moving through the peak will be for nominal GDP growth will slow quickly over the next six months, removing some of the cushion that has protected corporate profits, tax receipts and wage growth.
2. The household sector continues to hold a significant buffer of excess savings which can be used to smooth consumption growth amid acute cost of living pressures. Nevertheless, our analysis suggests that the residual of the savings buffer skews to older households, leaving younger and more indebted households exposed. As such, we remain particularly cautious on discretionary retail spending.
3. Australia remains incredibly well placed to benefit from the global energy transition. Lithium is already a A$10bn export industry domestically and Australia is the world's dominant producer. Electric Vehicle sales are forecast to increase 10 times by 2030 and Australia has the world's second largest copper resource. LNG is an important energy transition fuel – it currently accounts for 23% of global electricity generation – and Australia just happens to be the world's equal largest exporter of LNG. The limiting factor nearer term is that escalating costs and project delays risk pushing out the economic benefits.
4. Net migration into Australia contracted in 2021 for the first time since 1945. However, a very strong recovery was recorded through 2022 and a record level of net migration has occurred in recent months, ensuring that Australia's population growth will exceed 2% in 2023. This will be the primary mechanism keeping Australia out of recession, yet it comes with the complication of exacerbating the rental shortage evident across all capital cities.

While the RBA has been later than most other developed nations, we believe financial conditions are now firmly in the restrictive zone. While interest rate hikes in Australia will remain a month-to-month proposition for the next six months, our bias is that the RBA should have concluded its hiking cycle. However, we do expect that the RBA will commence a modest easing cycle in 1H24.

The A$/US$ had been under downward pressure as markets grappled with a seemingly more hawkish Fed and a relatively more dovish RBA. However, the RBA has recently sounded more hawkish than the Fed the A$ has started to appreciate. With Australia's external accounts remaining in excellent health, our expectation that Australia's economic growth will prove more robust, and the prospect the US$ down trend will persist as the Fed pivots from its hiking strategy to an easing cycle in early 2024, we expect the A$/US$ will appreciate to the mid-70s towards mid-2024.

We are most overweight stocks within the Communication Services, Information Technology and Consumer Discretionary sectors and are underweight Health Care, Real Estate and Industrials.

## Sector allocation

| | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| Communication Services | 14.39 | 4.60 | 9.80 |
| Consumer Discretionary | 10.52 | 7.42 | 3.10 |
| Consumer Staples | 0.00 | 3.66 | -3.66 |
| Energy | 0.00 | 3.11 | -3.11 |
| Financials | 12.74 | 16.00 | -3.26 |
| Health Care | 4.62 | 9.01 | -4.39 |
| Industrials | 8.90 | 12.98 | -4.08 |
| Information Technology | 12.69 | 7.05 | 5.65 |
| Materials | 20.53 | 21.10 | -0.56 |
| Real Estate | 7.18 | 11.32 | -4.14 |
| Utilities | 5.17 | 3.75 | 1.42 |

## Top 5 holdings

| | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| QBE Insurance | 5.38 | 2.62 | 2.76 |
| Origin Energy | 5.17 | 1.63 | 3.54 |
| Carsales.com | 4.66 | 1.04 | 3.62 |
| Resmed | 4.62 | 1.46 | 3.16 |
| Worley | 4.56 | 0.72 | 3.84 |

## Key active positions

| **Overweights** | Portfolio % | Benchmark % | Active % |
|---|---|---|---|
| Reliance Worldwide | 4.34 | 0.37 | 3.96 |
| Worley | 4.56 | 0.72 | 3.84 |
| Carsales.com | 4.66 | 1.04 | 3.62 |
| **Underweights** | | | |
| Brambles | 0.00 | 2.18 | -2.18 |
| James Hardie | 0.00 | 2.14 | -2.14 |
| Suncorp | 0.00 | 2.01 | -2.01 |

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 | 15.37 | 10.27 | 3.06 | 4.34 |
| Distribution return | 2.16 | 2.36 | 2.36 | 2.64 |

The Growth Return is measured by the movement in the Fund's unit price, 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 Australian Securities Exchange listed securities excluding the largest 20 by market capitalisation (as defined by the S&P/ASX 20 Index). In doing so, the aim is to outperform the S&P/ASX 300 ex S&P/ASX 20 Accumulation Index over rolling 3-year periods. |
| Recommended investment time frame | 5 - 7 + years |
| Fund inception | August 2010 |
| Fund size | A$12.2 mn as at 31 July 2023 |
| APIR code | JBW0052AU |
| Estimated management cost | 0.90% p.a |
| Buy/sell spread | +/- 0.15% |
| Platform availability | BT Panorama Praemium Hub24 |

## Applications and contacts

Investment into the Yarra Ex-20 Australian Equities Fund can be made by Australian resident investors only.

**Website** www.yarracm.com

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