

# Yarra Ex-20 Australian Equities Fund

## Gross returns as at 31 May 2021

	From 25 July 2018 <sup>A</sup>	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	3.59	-0.02	5.93	23.06	4.86	6.33	7.65	7.67
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index <sup>#</sup>	7.21	0.42	6.88	22.55	NA	NA	NA	NA
Excess return (before fees) <sup>‡</sup>	-3.62	-0.44	-0.95	0.51	NA	NA	NA	NA

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

	From 25 July 2018 <sup>A</sup>	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	2.64	-0.10	5.69	21.96	3.90	5.19	6.39	6.40
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index <sup>#</sup>	7.21	0.42	6.88	22.55	NA	NA	NA	NA
Excess return (after fees) <sup>‡</sup>	-4.57	-0.51	-1.19	-0.59	NA	NA	NA	NA

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.

<sup>A</sup> Effective 25 July 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. See [here](#) for further information.

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.

<sup>#</sup> 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.

<sup>‡</sup> Excess return: The difference between the Fund's return and the benchmark return.

### Market review

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

The S&P/ASX 300 Ex-20 Accumulation Index rose 0.4% during the month, taking its 12-month return to 22.6%. The benchmark underperformed the broader ASX300, which returned 2.3% as the major banks provided support 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 Financials (+3.3%), QBE insurance (QBE, +11.1%) was the top benchmark contributor after its 1Q21 update highlighted ongoing strong pricing and earned premium growth. Other top performers included Suncorp (SUN, +5.8%) and ASX Limited (ASX +4.5%).

Elsewhere, Gold (+13.1%) outperformed alongside the commodity, up 7.5% during the period to \$US1,900/oz. At a stock level the largest contributors included Northern Star

(NST, +11.3%), Evolution Mining (EVN, +16.8%) and Perseus Mining (PRU, +18.4%).

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 (-3.9%), Xero (XRO, -6.3%) delivered a disappointing FY21 result, and EML Payments (EML, -41.9%) faced pressure after an Irish regulatory body raised concerns about its PFS Card Services business.

### Portfolio review

#### Key Contributors

**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.

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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.

**QBE Insurance (QBE, overweight)** – the general insurer outperformed after delivering a strong AGM update. Management announced 1Q21 GWP growth of 13% on the pcp, supported by recent premium rate rises, and a combined operating ratio in line with expectations despite several catastrophe events in 1Q21. We continue to see upside to its relative valuation, with the stock trading on 14.7 times forward earnings and offering a 4.1% dividend yield, with strong underlying fundamentals remaining intact (global commercial hardening cycle).

**Kathmandu (KMD, overweight)** – the outdoor adventure retailer outperformed during the period without any material company-specific news. That being said, the company is seen as a key beneficiary of easing travel restrictions, particularly overseas. Following the resolution of the COVID crisis, our thesis remains premised on a positive view of its two acquisitions, Rip Curl and OBOZ, and its attractive category exposure as well as market share and margin expansion opportunities.

### 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.

**Northern Star (NST, underweight)** – the gold miner outperformed alongside the commodity during the period, with the gold price rising 7.5% to \$US1,900/oz. We remain underweight NST based on its stretched valuation metrics, at 7.0 times forward EV/EBITDA, and negative long-term view of the gold price. While we are positive towards the company's operations and its proposed merger with Saracen Minerals (SAR), we see significant downside risk to the commodity amid an outlook for higher real interest rates (which are generally a headwind to the gold price).

### Key Purchases

**IGO Limited (IGO)** – we established a 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.

**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.

**TPG Telecom (TPG)** – we increased our position in the telco during the period. Our positive view remains premised on the recently completed Vodafone merger, which in our view will unlock significant synergies. The combined entity is well placed to harness its infrastructure, scale and balance sheet to disrupt incumbents Telstra (TLS) and Optus through its lower-cost structure, in particular through its upcoming Fixed Wireless product. We also expect TPG's Mobile division (~55% of EBITDA) – which has been more impacted by the absence of international students and migrants versus peers – to recover following the resolution of the COVID crisis.

## Key Sales

**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.

**APA Group (APA)** – we trimmed our position to fund other opportunities but remain overweight the gas pipeline operator. Our positive view is based 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. The company will actually generate additional cash flows as weakness in oil end-markets reduces capex requirements, further protecting the dividend trajectory. In the medium term, we see dividend upside given the company's relatively high funding costs and conservative balance sheet position.

**Iluka Resources (ILU)** – we trimmed our position following recent outperformance. However, the mineral sands producer remains a high-conviction overweight in the portfolio. Our positive view is based on improving confidence that zircon and rutile markets are improving, with the current pace of the recovery exceeding our expectations. We regard the industry structure as attractive (consolidated supply), with less pricing volatility compared to previous cycles. As a result, we see ILU's valuation as attractive (at 6.8 times EV/EBITDA). While the outlook for rare earths appears promising in the context of a strong demand profile (as a component for electric vehicles) and potential government support, we ascribe limited value given it is long-dated opportunity with significant execution risks. We ascribe zero to ILU's valuation from Sierra Rutile after the company suspended operations due to ongoing poor financial performance.

## Key Active Overweights

**Vocus (VOC)** – we are overweight the telco on the grounds that it trades at 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. In the absence of a superior offer, we expect the takeover to be finalised in June following shareholder approval. Our original thesis in VOC was that the combination of good management, improving fundamentals and quality of the asset base would result in significant upside. The

management team had made significant progress in integrating and simplifying the various acquired businesses, unifying its product offering and increasing customer product penetration – driving significant longer-term revenue and margin opportunities.

**Iluka Resources (ILU)** – we are overweight the mineral sands producer based on improving confidence that zircon and rutile markets are improving, with the current pace of the recovery exceeding our expectations amid the global economic recovery. We regard the industry structure as attractive (consolidated supply), with less pricing volatility compared to previous cycles. As a result, we see ILU's valuation as attractive (at 6.8 times EV/EBITDA). While the outlook for rare earths appears promising in the context of a strong demand profile (as a component for electric vehicles) and potential government support, we ascribe limited value given it is long-dated opportunity with significant execution risks. We ascribe zero to ILU's valuation from Sierra Rutile after the company suspended operations due to ongoing poor financial performance.

**APA Group (APA)** – our overweight position is based on our view that APA's valuation – at an EV/EBITDA of 12.6 times and with a 5.3% forecast dividend yield – is attractive when considering its exposure to increasingly important gas markets and a 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 driven by lower funding costs, scope for a higher payout ratio and conservative balance sheet position.

## Key Active Underweights

**Sonic Healthcare (SHL)** – we are underweight the company on the grounds positive vaccine outcomes are likely to create an earnings headwind for the company which, in 2020, saw significant earnings support from its COVID-19 testing services. While short-term earnings will remain robust, we expect EBITDA to decline in FY21 as fewer tests are issued. We no longer view its valuation as sufficiently compelling versus alternatives, with the company trading at 20.8 times forward earnings.

**Xero (XRO)** – we are underweight the accounting software provider because we believe its strong growth outlook is fully factored into its valuation, but its potential risks are not. XRO trades at 18.5 times EV/sales, reflecting lofty expectations for subscriber growth to accelerate as the company continues to expand overseas and for add-on products and services to drive higher average revenue per user (ARPU). However, international expansion carries significant risks due to greater competition in more fragmented markets, with significant ongoing product reinvestment required for XRO to maintain its advantages relative to peers.

**Sydney Airport (SYD)** – our underweight position is premised on the outlook for a more protracted recovery in international travel, underappreciated risks arising from airline and tenant agreements and the prospect of higher interest rates in the

long term. Most airline agreements are scheduled for renewal in July 2021 which, if they are not extended, may result in adverse pricing outcomes for the airport operator. While we continue to view SYD's assets as high-quality with strong barriers to entry, we see the stock as fully valued at a CY22 EV/EBITDA of 24.0 times earnings when considering these risks.

## 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 Energy sectors, and are underweight Financials, Real Estate and Industrials.

## Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	16.94	5.23	11.71
Consumer Discretionary	11.15	9.20	1.96
Consumer Staples	3.15	3.35	-0.21
Energy	8.84	5.52	3.31
Financials	8.28	14.56	-6.27
Health Care	8.39	8.95	-0.56
Industrials	5.70	9.70	-4.00
Information Technology	6.78	7.00	-0.22
Materials	17.67	21.11	-3.44
Real Estate	6.68	12.74	-6.06
Utilities	4.79	2.64	2.15

## Top 5 holdings

	Portfolio %	Benchmark %	Active %
James Hardie Industries	5.76	2.19	3.57
APA	4.79	1.25	3.54
Atlas Arteria	4.32	0.68	3.65
Vocus	4.24	0.39	3.85
QBE Insurance	4.19	1.85	2.35

## Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Vocus	4.24	0.39	3.85
APA	4.79	1.25	3.54
Link Administration	3.91	0.31	3.60
Underweights			
Sonic Healthcare	0.00	1.90	-1.90
Xero	0.00	1.83	-1.83
Sydney Airport	0.00	1.81	-1.81

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.	Since inception % p.a.
Growth return	20.15	1.66	2.50	3.70
Distribution return	1.81	2.23	2.70	2.70

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\$14.1 mn as at 31 May 2021	
APIR code	JBW0052AU	
Estimated management cost	0.90% p.a	
Buy/sell spread	+/- 0.15%	
Platform availability	Asgard BT Panorama BT Wrap Hub24	Macquarie Wrap Accumulator Macquarie Wrap Consolidator

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## Applications and contacts

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

**Website** [www.yarracm.com](http://www.yarracm.com)

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