YARRA
CAPITAL MANAGEMENT

Investment Commentary
Month to 31 October 2022

Yarra Ex-20 Australian Equities Fund

Gross returns as at 31 October 2022

	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	3.02	6.05	-1.39	-5.65	1.83	4.71	7.80	6.98
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	4.83	6.04	-1.19	-7.52	3.09	NA	NA	NA
Excess return (before fees)‡	-1.81	0.02	-0.20	1.86	-1.26	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 October 2022

	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	2.08	5.97	-1.61	-6.50	0.93	3.71	6.59	5.75
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	4.83	6.04	-1.19	-7.52	3.09	NA	NA	NA
Excess return (after fees)‡	-2.75	-0.06	-0.42	1.02	-2.17	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.

^ **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. 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.

\# 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

Australian equities rallied sharply during October, following the 6.2% decline in September.

The S&P/ASX 300 Ex-20 Index returned 6.0% for the month, taking its 12-month return to -7.5%. The broader ASX 300 also added 6.0% for the month, while global indices notched up strong gains in October (MSCI World Index, +7.2%).

Real Estate was a strong performer (+9.8%), rebounding somewhat from a 30% year to date decline prior to October, led by Arena REIT (ARF, +18.0%), National Storage REIT (NSR, +17.0%) and Centuria Industrial REIT (CIP, +17.0%).

Consumer demand and retailer confidence in the resilient retail sector enabled Consumer Discretionary (+9.3%) to continue its recovery over the first quarter, led by Flight Centre travel (FLT, +17.0%), Domino's Pizza (DMP, +23.7%) and PWR Holdings (PWH, +18.6%).

The lowest performing sector in October was Energy (+2.6%) led by Worley (WOR, +12.1%), Paladin Energy (PDN, +12.6%) and negative performance in Cooper Energy (COE, -17.6%).

Key Contributors

Link Group (LNK, overweight) – the company's share price recovered somewhat during the month following sharp underperformance in the prior month following termination of the agreed deal with Dye & Durham to buy the company. We still see considerable value in LNK and a pathway to crystalizing this value and regard the announced demerger of its stake in PEXA as an appropriate first step. LNK received a substantial bid from Dye & Durham for its Corporate Markets and Banking & Credit Markets businesses during the month which further highlights the value in the constituent parts of LNK.

Medibank (MPL, underweight) – our underweight position in the private health insurer contributed to performance as the stock came under significant pressure following news of a cyber incident comprising customer personal information.

While the company has suggested the incident is expected to impact FY23 earnings by $25-35mn, we believe the true cost of the incident won't be felt for some time through damage to brand, customer retention, potential remediation, regulatory and litigation costs. With the underlying business continuing to experience 'above normal' operating conditions via lower underlying claims, we continue to hold an underweight position, with the stock continuing to demand a relatively strong P/E multiple of 16.8 times 12-month forward earnings.

QANTAS Group (QAN, overweight) – the Australian airline outperformed during the month, updating the market on very strong expected earnings for the current half. QAN expects to earn $1.2b to $1.3b profit before tax in 1H23, which is 25% ahead of full year FY23 consensus earnings. This strengthening has come through improved market share, high load factors and very strong pricing given the strong demand backdrop for both domestic and international travel.

Key Detractors

Reliance Worldwide (RWC, overweight) – the plumbing supplies company underperformed during the period following the release of its 1Q23 result which showed volumes are softening modestly across the business (-1.9% in 1Q) and expectations that volumes will be down mid-single digits in the Americas division over FY23. Margins were also weak at 21.4% (ex EZ Flo), with the price recovery for cost inflation insufficient to cover cost inflation in the quarter. Over the full year, raw material costs should deflate, which should mean that margins improve over the full year. Whilst the quarterly result was weak, we regard the sell-off as over-done and retain our conviction in the longer-term investment thesis.

OZ Minerals (OZL, overweight) – the copper miner was a negative contributor in October despite no incremental news, with BHP's takeover offer for the company weighing on share price performance. With the OZL board rejecting the initial offer, we recognize the potential for BHP to return with a higher bid and regard the potential for a counterbidder to emerge as limited, given BHP's significant available regional synergies. We retain our fundamental positive view on OZL due to its two high quality, long life, 100% owned copper mines in South Australia – Prominent Hill and Carrapateena. We expect the company's copper production to double to >200ktpa by 2030, as Carrapateena moves to a block caving operation, and the company develops the greenfield West Musgrave copper/nickel deposit in Western Australia.

NextDC (NXT, overweight) – the data centre operator underperformed the market during the month on limited news flow. We believe the high recurring nature of NXT's revenues, its infrastructure like characteristics and tangible asset base are attractive. NXT has been excessively discounted and we see no diminution to its growth trajectory. NXT trades on 20.1 times FY2024 EV/EBITDA, which compares favorably to its more mature global peers.

Key Purchases

Sandfire (SFR) – we increased our exposure to the copper producer during the period, reflecting our conviction in the commodity given its leverage to electrification as a key material in batteries and electric motors. While we recognise risks of an oversupplied market in the near term, we believe recent falls in copper prices are now largely complete given cost curve support. While Sandfire faces near-term challenges including gearing levels, power costs at the MATSA project in southern Spain, and construction risk at the Motheo project in Namibia, we believe these risks have been significantly over-priced and see upside value at current share price levels.

Evolution Mining (EVN) – we added the gold producer to the portfolio during the period. The stock has significantly underperformed listed gold peers in recent months due to disappointing production levels and guidance downgrades. While gearing approaching 30% means EVN is more highly geared than peers, we believe the company represents compelling value, with risks of an unexpected capital raising to support the balance sheet considerably over-played in our view. AUD denominated gold prices remain robust, and we continue to see price support for gold in the near to medium term.

The Lottery Corporation (TLC) – we took the opportunity to add to our existing TLC position. We view the lotteries business as highly defensive with low elasticity to the domestic economy, both attractive characteristics for the economic environment that we are likely entering. While jackpot activity has created a short-term earnings vulnerability, we expect this will normalise over time, creating an opportunity to add to the position. We are attracted to the undemanding valuation metrics for what remains a high-quality business; TLC trades on a 12-month forward EV/EBITDA multiple of 12.3 times and offers a 3.5% dividend yield.

Key Sales

James Hardie (JHX) – we exited the remainder of our position following a review of earnings sustainability through a more challenging residential environment. While 65% of JHX's end-market in the US is exposed to the more resilient Repair & Remodel market, we note it is heavily skewed to remodelling activity where we see a more challenging outlook; higher interest rates following a period of strong demand through the 'stay at home' dynamic created by the COVID pandemic represent a key headwind. Notwithstanding an undemanding current P/E multiple of 12.6 times forward earnings, we see downside risk to earnings in excess of market expectations.

Northern Star (NST) – we trimmed our position in Northern Star following a period of outperformance relative to peers Newcrest (NCM) and Evolution Mining (EVN) but remain overweight the gold producer. Northern Star has demonstrated strong cost control, with FY23 cost guidance implied inflation pressures expected to remain lower than peers (+6% at the mid-point). We believe the company's ownership of power assets in Kalgoorlie, coupled with a lack of exposure to Australia's east coast power market – in contrast to NCM and EVN – remain key differentiators for NST.

Insurance Australia Group (IAG) – we trimmed our position during the month following a period of outperformance but remain overweight the general insurer. The company received further positive court rulings on COVID-19 related business interruption test cases during the month, which saw it release $360m of related provisions and announce a $350m buyback. IAG retains a further $615m of COVID-19 related provisions, hence we expect further provision releases and buybacks as greater clarity emerges.

Key Active Overweights

Link Group (LNK) – despite the uncertainty created by the failed takeover bid from Dye & Durham and UK regulatory action on its Fund Solutions business, we still see considerable value in LNK's constituent parts and a pathway to crystalizing this value. In the interim LNK's two main operating businesses are performing well, with two upgrades to guidance provided in the last six months.

Reliance Worldwide (RWC) – we remain positive on the compelling opportunities within the plumbing supplies company. While the market pricing for a significant decline in earnings (as reflected in the forward P/E of only 11.0 times), we remain constructive on the demand environment – both in the trough and longer term – given the defensive nature of the majority of RWC's repair and remodelling sales. Approximately 80% of RWC's sales are repair and remodel, which is not tightly correlated with the housing sector, while 60% of US sales are for repairs which are more defensive in nature.

Carsales.com (CAR) – we remain overweight the online car classifieds company and participated in CAR's recent equity raising to acquire the remaining 51% in Trader Interactive, a US online classifieds business with strong potential for growth 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). Longer term, we remain overweight CAR based on improving yield from products such as Instant Offer and Select, as well as the improving profitability of Encar, CAR's South Korean business.

Key Active Underweights

South32 (S32) – we maintain a negative medium to longer-term view towards the company. In our view S32's key commodity prices remain unsustainably high despite recent price falls. While manganese and coking coal prices have declined, they remain well above cost curve support. With these two commodities representing around 50% of S32's earnings, we see earnings risk skewed to the downside, based on supply and demand fundamentals. The company faces increasing inflation pressures across its portfolio from rising energy and labour costs. S32 appears devoid of growth opportunities, with short mine lives, no active exploration, increased capital intensity and material geopolitical risk from its South African operations.

Brambles (BXB) – we are underweight the global provider of pallet pooling solutions to various FMCG producers. We remain cautious on the normalisation of pallet volumes and the company's ability to drive medium term growth in key markets such as the US. The normalisation of lumber prices is providing near term relief to margins but we believe the longer term margin profile is mature.

Sonic Healthcare (SHL) – we are underweight the global pathology and radiology provider on the grounds that normalisation of COVID-19 testing volumes are likely to create an earnings headwind for the company which has seen significant earnings support from these services. While short-term earnings will remain robust, we expect EBITDA to decline in FY23 as fewer COVID-19 tests are issued. We do not view its valuation as sufficiently compelling versus alternatives, with the company trading on 19.4 times elevated forward earnings.

Market outlook

Financial markets have now embraced the risk of recession in the US and Europe, and the gap between our more pessimistic forecasts for the global economy and the consensus has narrowed. Indeed, with the Fed signalling that financial conditions are close to neutral, we are edging closer to the point where the pace of monetary tightening will slow, providing some scope for risk markets to recover some lost ground.

The period of excess inflation is starting to recede, with prior surges in commodity prices retreating, an easing in supply constraints, and signs of slowing demand likely to compress elevated sales margins. As central banks continue to await firmer signs that inflation expectations have stabilised and for labour demand to ease, financial markets are faced with the positive news of less restrictive monetary policy and the negative news of likely weaker company earnings.

In a world of heighted concerns of recession in major developed economies, subdued economic activity in China and ongoing conflict between Russia and the Ukraine which has contributed to commodity shortages, high inflation and rising interest rates, the Australian economy presents as a relative safe haven.

Australia's economic data has remained robust in 1H2022, although we do expect economic activity to slow significantly in 2023 to average just 1.5%. While a local recession is possible in 2023, we believe Australia should be able to avoid a technical recession due to three key reasons:

1. Australia has been a net beneficiary of global commodity shortages. This surge in commodity prices saw Australia's export prices in A$ terms move to their highest levels since the 1880s in 1H2022. The consequence has been strong national income growth, profits growth and an improving underlying fiscal position.
2. The household sector continues to hold a significant buffer of over $160bn of excess savings relative to pre-COVID levels. Although we expect the impact of higher interest rates and higher living expenses will curtail consumer spending, we do expect the combination of rising wage growth and a run down in the level of savings to continue to support consumption spending.
3. Low levels of spare productive capacity, strong profit and low corporate debt have contributed to robust capital investment intentions.

Over the medium term we believe a recovery in net immigration levels into Australia and Australia's exposure to key commodities crucial to the global energy transition will provide a solid underpin for future economic growth.

While the RBA has been later than most other developed nations in tightening policy, tighter financial conditions in 2022 have come via both significantly higher cash rates, higher government bond yields and wider corporate bond spreads. We expect that the RBA cash rate will finish the year at 3.10%, which we expect will mark the peak for the RBA, well below market expectations of a 4.0% peak in 2H23. The A$/US$ has been particularly weak in recent weeks, albeit on a TWI basis the A$ has been broadly stable. With Australia's external accounts are in their best position since the early 1970s and the prospect the US$ uptrend will peak as the Fed pivots from its aggressive hiking strategy we expect the A$/US$ will appreciate to the mid-70s by end-2023.

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

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	14.15	4.37	9.78
Consumer Discretionary	8.70	7.66	1.04
Consumer Staples	1.85	4.49	-2.63
Energy	4.52	4.89	-0.36
Financials	10.79	14.04	-3.25
Health Care	4.76	8.93	-4.17
Industrials	12.70	10.21	2.49
Information Technology	13.57	7.96	5.61
Materials	23.30	22.17	1.13
Real Estate	0.00	12.15	-12.15
Utilities	3.97	3.14	0.83

Top 5 holdings

	Portfolio %	Benchmark %	Active %
QBE Insurance	5.34	2.18	3.16
IGO	5.19	1.24	3.95
Carsales.com	4.77	0.86	3.91
ResMed	4.76	1.60	3.16
Worley	4.52	0.64	3.89

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Link Administration	4.21	0.21	4.00
IGO	5.19	1.24	3.95
Reliance Worldwide	4.22	0.31	3.92
Underweights			
South32	0.00	2.01	-2.01
Brambles	0.00	1.95	-1.95
Sonic Healthcare	0.00	1.89	-1.89

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	-8.86	-1.13	1.17	3.82
Distribution return	2.36	2.05	2.54	2.77

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$10.8 mn as at 31 October 2022	
APIR code	JBW0052AU	
Estimated management cost	0.90% p.a	
Buy/sell spread	+/- 0.15%	
Platform availability	BT Panorama Hub24	Praemium

Applications and contacts

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

Website www.yarracm.com

Investor Services Team 1800 034 494 (Australia) +61 3 9002 1980 (Overseas) IST@yarracm.com