YARRA CAPITAL MANAGEMENT

Investment Commentary
Quarter to 30 September 2023

Yarra Ex-20 Australian Equities Fund

Gross returns as at 30 September 2023

	From 25 June 2018^	1 month$^{\delta}$ %	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	4.84	-4.18	-4.19	19.50	10.33	3.94	6.75	7.45
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	4.93	-4.36	-2.52	11.29	7.55	5.04	N/A	N/A
Excess return (before fees)‡	-0.10	0.18	-1.68	8.20	2.78	-1.11	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 30 September 2023

	From 25 June 2018^	1 month$^{\delta}$ %	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	3.89	-4.25	-4.41	18.43	9.35	3.00	5.59	6.24
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	4.93	-4.36	-2.52	11.29	7.55	5.04	N/A	N/A
Excess return (after fees)‡	-1.05	0.11	-1.89	7.14	1.80	-2.04	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.

$^{\delta}$ Note: Due to a Melbourne public holiday, Fund performance in September 2023 was calculated up to 28 September 2023, whereas Benchmark performance is shown to 29 September 2023. Fund performance for 29 September 2023 will be captured in October 2023 month-end performance. Further information relating to Unit Pricing calculations can be found in the Fund PDS.

^ 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

Australian equities weakened during the September quarter, with the Energy sector being the top performer and the Health Care sector delivering the weakest performance.

The S&P/ASX 300 Ex-20 Accumulation Index returned -2.5% for the quarter, taking its 12-month return to +11.0%. In comparison, the broader ASX300 fell by 0.8% for the quarter and, globally, the MSCI World Index saw a decline of 3.4% for the period.

Energy (+21.2%) was the best performing sector during the period, with all sub-sectors performing well. The main contributors of outperformance were Ampol (AMP, +16.0%) and Paladin Energy (PLD, +50.7%). Ampol benefitted from rising Brent oil price and Paladin the uranium price increase of ~20% for the quarter.

Within Communication Services (+8.3%), Carsales.com (CAR, +18.6%) was a key driver of the sector's return. The online car classifieds company demonstrated strong yield growth potential across all its operating segments. REA Group (REA, +8.4%) was also a notable stock contributor for the period.

By contrast, the worst performing sector for the quarter was Health Care (-9.1%). ResMed (RMD, -27.9%) was one of the main detractors due to concerns around a range of factors including gross margins, the competitive landscape and the impact of emerging weight loss drugs which may adversely impact the addressable market for sleep-apnoea device sales.

Portfolio review

Key Contributors

Carsales.com (CAR, overweight) – the online auto classifieds company outperformed during the period following its full-year result. The result proved up CAR's investment case of the recent acquisitions of Trader Interactive in the US business and Webmotors in Brazil, with both businesses demonstrating

double digit yield growth as dynamic pricing models were introduced. Combined with a strengthened market position in Australian private car sales, there is now much greater visibility around continued price and yield increases across the business.

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

Incitec Pivot (IPL, overweight) – the fertiliser and explosives company outperformed during the period following a solid FY23 trading update. While the fertiliser division had a weak 2H23, explosives posted a strong recovery. The company announced stronger ammonia mining production volumes from Moranbah AN (30-40kt above guidance). The sale process for IPL's fertilisers business is ongoing and the buyback remains on hold.

Key Detractors

Resmed (RMD, overweight) – our overweight position in the medical equipment manufacturer detracted during the month following the release of its full-year results. We would characterise the share price weakness as driven by firstly an increased focus on the potential future impact of weight loss drugs GLP-1s on the sleep-apnoea market and, secondly, an eventual return of competitor Phillips into the sleep-apnoea device market in the USA. There was also a degree of gross margin disappointment following delivery of the company's full year result. Notwithstanding the above factors, we continue to see a solid market penetration outlook for RMD's CPAP devices, and hence believe these are factored into expectations at current levels with the stock trading on an attractive valuation (21.7 times P/E FY24 vs 28.1 times long-term average).

Iluka Resources (ILU, overweight) – our overweight position in the mineral sands company was a detractor during the quarter. Iluka reported a 10% decline in mineral sands revenue and a 22% decline in underlying EBITDA in its FY23 results, with the market concerned over the short-term outlook for mineral sands demand notwithstanding ILU's commentary of flat pricing in the second half. We continue to like mineral sands markets long-term and favour ILU 's leverage as the world's largest Zircon producer and fifth largest producer of titanium feedstocks. Iluka is moving into Rare Earths production through the Eneabba refinery and should be a critical component producer for the EV industry.

Alumina (AWC, overweight) – our overweight position in the alumina producer was a detractor during the period following its half-year results. We are concerned that environmental approvals to mine near to the Serpentine dam may not be received in a timely manner, and the company has less than 12 months of remaining low-grade ore to mine at Huntly. We see a material risk that the Kwinana and Wagerup refineries may be forced to curtail production or even close at a time where the company's debt levels are approaching unsustainable levels. This has led us to exit the stock position.

Key Purchases

APA Group (APA) – we initiated a position in the gas transmission pipeline company via participation in an equity raising used to fund the Alinta's Pilbara assets. The acquisition of the Alinta assets gives APA an attractive platform to deploy capital into the decarbonisation of mining operations in the Pilbara through the development of renewable generation and transmission infrastructure. APA trades on a valuation of 11.3 times FY24 EV/EBITDA and a 6.5% dividend yield, which we view as an attractive entry point.

Stockland (SGP) – we increased our 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. Stock 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-22) and attractive valuation, with the stock trading at 0.80-times net asset backing and offering a dividend yield above 6%.

ResMed (RMD) – we added to our RMD position to take advantage of a recent share price weakness following the release of the FY23 results. The stock has sold off due to concerns around a range of factors including gross margins, the competitive landscape and the impact of emerging weight loss drugs which may impact the addressable market for sleep-apnoea device sales. We are not as bearish on these issues, with our favourable view predicated on RMD's large and underpenetrated market (sleep and COPD (chronic obstructive pulmonary disease)), clear operating leverage over time and its strong track record of capital deployment as the business shifts further into digital, connected care solutions for its patient base. We took the opportunity to add to the position, with the stock trading at an attractive valuation (21.7 times P/E NTM vs 28.1 times long-term average).

Key Sales

Alumina (AWC) – we exited our position in the alumina producer following the company's 1H23 result. We are concerned that environmental approvals to mine near to the Serpentine dam may not be received in a timely manner, and the company has less than 12 months of remaining low-grade ore to mine at Huntly. We see a material risk that the Kwinana and Wagerup refineries may be forced to curtail production or even close at a time where the company's debt levels are approaching unsustainable levels.

United Malt (UMG) – we exited our position in the global commercial malt processor and distributor as Malteries Soufflet signed a binding deal to purchase UMG at $5 a share (a +45% premium to the undisturbed price) following an extensive period of due diligence. UMG is trading close to deal terms and as a result we see limited potential for further outperformance.

TPG Telecom (TPG) – we took the opportunity to reduce our position in the Australian telco after a period of outperformance, reflecting the potential $6.3bn sale of its Vision/EG&W assets and a strong 1H23 result. However, the proposed sale also concentrates TPG's exposure in mobiles, with medium term earnings growth contingent on repricing and ongoing mobile rationality. This may prove more challenging as inflation eases and CPI-linked increases moderate, while the outlook for mobile competition remains a risk given Optus has yet to move postpaid pricing.

Worley (WOR) – we took the opportunity to trim the size of the WOR overweight following strong performance after the release of the company's 1H23 result. The company continues to grow engineering service revenues into both traditional and renewable energy end markets at strong double-digit rates, with margins continuing to improve over time.

Key Active Overweights

Carsales.com (CAR) – we are overweight the online car classifieds company which has demonstrated strong yield growth potential across all its operating segments. In Australia, which represents approximately 50% of CAR's valuation, CAR is seeing improving yields from products including Instant Offer and SELECT, along with a strengthened competitive position in private sales. CAR's acquisitions of US business Trader Interactive and Brazilian business Webmotors have both demonstrated strong yield growth as new dynamic pricing models are introduced. The visibility on CAR's medium term revenue growth has improved which makes the 31.5 times FY24 earnings multiple the stock trades on relatively undemanding given the tailwinds.

ResMed (RMD) – we remain overweight the medical device company with a positive view of the potential growth opportunity. The stock sold off during the quarter due to concerns around a range of factors including gross margins, the competitive landscape and the impact of emerging weight loss drugs which may impact the addressable market for sleep-apnoea device sales. We are not as bearish on these issues, with our favourable view predicated on RMD's large and underpenetrated market (sleep and COPD (chronic obstructive pulmonary disease)), clear operating leverage over time (SG&A and R&D) and a strong track record of capital deployment as the business shifts further into digital, connected care solutions for its patient base.

Worley (WOR) – we remain overweight the leading provider of global engineering services. WOR's earnings recovery is in its early stages following the COVID-19 impacts across FY20-22. Revenue is expected to grow 13-15% in FY24, 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 increase over the coming years as WOR benefits from a more consolidated industry structure, operating leverage, and active mix management.

Key Active Underweights

Brambles (BXB) – we remain underweight the global provider of pallet pooling solutions to various FMCG producers. Supported by a favourable pricing environment, Brambles currently has strong momentum, generating 14% revenue growth and 19% EBIT growth in FY23, with improving free cash flow. Looking forward, however, we are cautious on the sustainability of the current high level of profit growth as customer demand and pricing dynamics normalise.

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., share growth, a responsive operational and manufacturing footprint), we remain cautious of 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 16.8 times forward P/E. Our preferred building material company remains Reliance Worldwide (RWC), which trades on 14.0 times FY24 earnings.

Suncorp (SUN) – we remain underweight to 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 maintain a positive outlook for domestic general insurance, which will benefit SUN, we also see risk that the deal to sell SUN's bank to ANZ may not proceed in its current form, following the ACCC's published concerns.

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.

Moreover, the pessimistic tone of the economic activity data in the US that threatened a technical recession has given way to slightly more upbeat 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.

Indeed, our leading indicators suggest the negative earnings per share revisions trend has now largely run its course which when combined with a levelling out in economic momentum and an end to the interest rate tightening cycle will likely provide greater confidence in underlying valuations and a shift

from bearish equity positioning. 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 0.4%q/q growth in the June quarter, repeating the same languid growth recorded in the March quarter. Indeed, with population growth running at a 2.5% annualised pace in the six-months to June and economic growth expanding at an annualised 1.8% pace over the same period, Australia has recorded its first per capita recession since mid-2006 (excluding the COVID lockdown period). It is clear the prior tightening of monetary policy is having a material impact on the interest rate sensitive parts of the economy. For instance, discretionary consumption volumes have declined 0.6% (six-month annualised) as non-discretionary household expenses and interest costs soared by 16%yoy – the fastest annual increase since 1989. Building approvals continue to decline – now down 45% from the 2021 peak - and are likely to fall further in coming months as declining housing affordability outweighs the impact of an under supplied housing market.

Nevertheless, the good news is that after a pause in the tightening cycle in July, The Reserve Bank of Australia (RBA) has remained on hold 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. It is of note the that the RBA's forecasts for domestic growth are now below our own for the first time since 2019.

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. Although commodity prices remain elevated from a historical perspective, they are now off their peaks., The impact of moving through the peak will be for nominal GDP growth to 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 2.5% 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, our analysis suggests that the RBA should have concluded its hiking cycle. Moreover, we do expect that the RBA will commence a modest easing cycle in 1H24, most likely commencing in May 2024.

The A$/US$ had been under downward pressure as markets grappled with a seemingly more hawkish Fed relative to the RBA and poor sentiment on the economic outlook for China. However, 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 re-emerge as the Fed pivots from its hiking strategy to an easing cycle in early 2024, we expect the A$/US$ will appreciate to the low-70s towards mid-2024.

We are most overweight stocks within the Communication Services, Information Technology and Utilities are underweight Materials, Industrials and Energy.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	15.09	4.77	10.32
Consumer Discretionary	10.18	7.63	2.55
Consumer Staples	0.00	3.61	-3.61
Energy	0.00	3.78	-3.78
Financials	13.03	16.12	-3.09
Health Care	5.32	8.50	-3.18
Industrials	9.12	13.10	-3.98
Information Technology	12.34	6.99	5.36
Materials	17.08	21.09	-4.01
Real Estate	7.58	10.64	-3.06
Utilities	8.53	3.76	4.77

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Carsales.com	5.81	1.23	4.58
QBE Insurance	5.64	2.75	2.90
Origin Energy	5.64	1.77	3.87
ResMed	5.32	1.08	4.24
Worley	4.82	0.75	4.07

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Carsales.com	5.81	1.23	4.58
ResMed	5.32	1.08	4.24
Worley	4.82	0.75	4.07
Underweights			
Brambles	0.00	2.33	-2.33
James Hardie Industries	0.00	2.10	-2.10
Suncorp Group	0.00	2.07	-2.07

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	16.26	7.05	0.69	2.99
Distribution return	2.18	2.29	2.31	2.60

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$11.4 mn as at 30 September 2023
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.

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