Yarra Investment Fund

Total returns as at 30 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 Investment Fund^	2.48	7.10	10.39	7.12	8.41	6.27	10.45
S&P/ASX 200 Accumulation Index†	3.27	8.47	13.01	9.03	9.97	6.40	N/A
Excess return‡	-0.79	-1.38	-2.62	-1.91	-1.56	-0.13	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.
* Inception date Yarra Investment Fund: December 1984.
^ This Fund is no longer available for new investment. The Reinvestment of distributions is still allowed where an existing Reinvestment instruction is in place.
† Since April 2008 the benchmark for the Yarra Investment Fund is the S&P/ASX 200 Accumulation Index
‡ Excess return: The difference between the Fund's return and the benchmark return (S&P/ASX 200 Accumulation Index).

Market review

The Australian equities market rallied in the June quarter, generating its best quarterly return since March 2015.

The S&P/ASX 200 Accumulation Index returned 8.5% in the three months to 30 June 2018, taking its 12 month return to 13.0%. The local index outperformed global indices, with the MSCI World Index returning 3.8% in the quarter and 11.5% for the year.

The Federal Government's 2018-2019 budget was released during the quarter, with only a small impact on equity markets. The government continues to focus on infrastructure projects (positive for engineering and construction companies) and announced plans for tax relief for lower and middle income earners, which may incentivise higher consumer spending over the long-term.

Resources stocks contributed most to the index's return in the quarter. Iron ore majors BHP Billiton (BHP, +20.2%) and Rio Tinto (RIO, +14.8%) supported Metals & Mining (+15.1%) as the iron ore price remained at around $US65 per tonne, defying expectations for it to decline. BHP also benefited from its exposure to oil as WTI crude lifted 14% to $US74 per barrel. Energy (+19.7%) was the top performer with all constituent companies – including Woodside (WPL, +21.3%), Origin Energy (ORG, +15.3%) and Oil Search (24.5%) – rising during the period.

In the Industrials space, the Banks (+3.4%) saw relief in the quarter while Health Care (+16.5%) generated strong returns driven by CSL (+23.9%). The biotechnology company upgraded its FY18 guidance in response to faster-than-expected take up of its new products. The only sector to decline in the quarter was Telecommunication Services (-13.7%). Telstra (TLS, -16.6%) downgraded its FY19 earnings guidance due to weakness from its Mobile division, which management is relying upon to drive earnings growth.

Sector performances during the quarter were very similar to the 12 month period, where Metals & Mining (+40.1%), Energy (+41.6%) and Health Care (+27.7%) were among the top performers, along with Consumer Staples (+29.1%). Staples rallied in response to strong returns from Wesfarmers (WES, +29.8%), Woolworths (+23.8%), A2Milk (A2M, +179.8%) and Treasury Wine (TWE, +34.5%). The only sectors to make negative returns in the period were Banks (-1.1%), Utilities (-0.8%) and Telecommunication Services (-30.9%)

Portfolio review

Key contributors

Telstra (TLS, underweight) – the telco underperformed following a series of negative trading updates. In May the company provided a worse-than-expected 3Q18 trading update and, at its strategy day in June, announced a 15% downgrade to FY19 earnings (at the midpoint). Weak performance from its Mobile division (47% of underlying EBITDA) was primarily responsible for the downgrade. Management was relying on Mobile to drive earnings growth during the NBN roll-out period but the division, as a result of significant competitive pressure, will now drag on earnings. The update supported our thesis that TLS faces earnings headwinds across all divisions: competition is intensifying as TPG Telecom (TPM) enters the mobile market, increasing pressure on TLS's market share and margins, and the fixed line businesses face significant structural and competitive challenges. We also believe there are risks of lower future NBN payments and remain sceptical that TLS can fill its $2-3bn EBITDA shortfall when NBN payments conclude and the company faces higher access costs. Consequently, we do not believe the headline 12-month forward P/E of 13.6 times provides appropriate valuation support.

National Australia Bank (NAB, underweight) – the bank underperformed following an underwhelming 1H18 result. While headline metrics were in line with expectations, there was little revenue momentum with net interest income falling 0.3% and consumer interest income flat. NAB reiterated its guidance for expenses to grow 5-8% in FY18 and remain flat in FY19 and FY20, which we believe is not sustainable given significant catch-up investment is required. The company also announced its planned divestment of wealth business MLC by way of either an IPO, demerger or a trade sale. In our view this will be a complicated business extraction, will likely result in further restructuring charges and could become capital consuming. We do not regard NAB's valuation – at 11.6 times forward earnings and 1.4 times book value – as being appealing when considering these headwinds.

AMP (AMP, underweight) – AMP fell sharply in value early in the quarter after being found by the Financial Services Royal Commission to have misled corporate regulators over misconduct in its advice business. As a result of the revelations the chief executive and chair stepped down and a comprehensive and independent review was announced into AMP's regulatory reporting and governance processes. We remain underweight the stock. In our view the reputational damage may limit growth opportunities, increase costs, inhibit AMP's ability to sell businesses and will constrain the stock's valuation (currently at a 12-month forward multiple of 10.5 times). Outside of this AMP's business remains structurally pressured, with continued margin compression in its wealth management division.

APN Outdoor (APO, overweight) – the outdoor advertising company outperformed during the quarter after accepting an improved takeover offer from French suitor JCDecaux at the end of June. Following an initial offer of $6.52 per share in cash, JCDecaux subsequently increased it to $6.70 per share – a 15% premium to the stock's price prior to the announcement. We support the $1.2bn acquisition, which equates to an EV/EBITDA multiple of 13.0x – 30% higher than the ASX 200 Industrials at 10.0x and at a premium to other transactions in the industry (peer oOH! Media (OML) purchased Adshel for 11.6x during the quarter). We continue to hold an overweight position, with APO trading at a 6% discount to the bid. In our view the likelihood that the ACCC blocks the deal is low when the combined entity would only account for 34% of total outdoor advertising industry revenues.

Santos (STO, overweight) – the oil and gas producer outperformed in response to the higher oil price, with Brent crude rising 14.7% to $US79 per barrel, and after receiving a takeover proposal from US-company Harbour Energy, which it subsequently rejected. Management's reasons included the nature of the debt package (a highly leveraged private equity backed structure), the requirement for significant support from STO management for the debt raising and Foreign Investment Review Board (FIRB) approval risk. Our original investment thesis remains intact: following several operational improvements that have reduced costs, STO is significantly cash flow positive at current oil price levels, with a cash flow breakeven price of around $US34/bbl. Management is also running ahead of its target to reduce net debt to below $US2bn by the end of 2019, and is progressing a number of attractive organic growth opportunities to crystallise the latent value in the company's portfolio..

Key detractors

CSL (CSL, underweight) – the company outperformed after upgrading FY18 net profit guidance by 7-8% to between $1.68-$1.71bn, which was 3.5% ahead of consensus expectations. A faster sales ramp-up in CSL's Idelvion and Haegarda businesses and more demand for Seqirus's higher value flu products drove the upgrade. We remain underweight CSL based on its forward valuation (32.9 times P/E and 23.1 times EV/EBITDA on a 12-month forward basis), which we believe fully captures the earnings growth outlook. Growth rates may also prove more challenging to achieve in the longer term given new product growth across the industry will largely come from the more competitive recombinant portfolio sector, where CSL's plasma product economics and relative competitive advantage are less relevant.

BHP Billiton (BHP, underweight) – the company outperformed in response to the higher oil price – WTI crude rose 14.3% to $US74 per barrel – and the iron ore price remaining firm at around $US65. BHP's 3Q18 production report was largely in line with expectations, with copper guidance slightly upgraded but iron ore guidance downgraded by 1-2% for FY18 as a result of operational issues. We maintain a cautious medium to longer term view towards BHP's commodity exposures, particularly iron ore and coal. We believe fundamentals point to lower prices as new supply comes onto the market and China's demand wanes from strong, stimulus-induced levels. Furthermore, the ability for BHP to support earnings through lower costs appears increasingly challenged – cost inflation is building (as evidenced in the 1H18 results) and capex will need to increase to more historic levels.

Star Entertainment (SGR, overweight) – the casino operator underperformed following a mixed trading update in the quarter. SGR's Sydney casino, the Star, weighed on revenue due to below average table hold rates in the top private gaming room tier. SGR also announced an expanded strategic partnership with Chow Tai Fook Enterprises and Far East Consortium International. Under the deal the pair take a combined 9.99% ownership in SGR through an equity placement. We remain overweight SGR as we believe the market currently underestimates SGR's ability to enhance asset performance through operational improvements and capex programs. The company's brownfield developments – the expansion in Sydney, the redevelopment in the Gold Coast and the Queen's Wharf in Brisbane – provide meaningful upside opportunities in the medium to longer term.

JB Hi-Fi (JBH, overweight) – the electronics retailer underperformed following a negative trading update, with FY18 net profit downgraded by 4.2% to $230mn. Management attributed the downgrade to lower gross margins from The Good Guys as a result of aggressive pricing from Harvey Norman (HVN). We remain overweight JBH despite the more conservative growth outlook for The Good Guys, as we still believe synergy, sales and margin opportunities exist following the acquisition of the company in November 2016. Our medium- term investment thesis remains in place, being that concerns regarding Amazon's recent entry into the Australian market are overdone with respect to JBH. Compared to its overseas counterparts, JBH has a more resilient business to withstand new competition, with lower prices and costs, greater sales density and a more sophisticated online offering.

TPG Telecom (TPM, overweight) – while there was no company specific news in the period, the telco underperformed amid heightened competitive pressure in the sector. Specifically, Telstra (TLS) announced it would rebase its mobile business in response to competitors and the impending entry of TPM, with new plans to be launched from July 2018 that will remove all out of bundle charges. We remain overweight the stock, which we believe offers compelling value relative to its peers (at a forward P/E of 14.6 times) when considering its defensive characteristics and disruptive growth opportunities from its entry into the Mobile market. Furthermore, in our view consensus forecasts now capture a lower contribution from iiNet – which we believe will be offset by material cost synergies – and the detrimental impact of the NBN roll-out on margins.

Key purchases

WorleyParsons (WOR) – we established a position in the engineering services company during the quarter. We expect WOR to benefit from its exposure to oil & gas (primarily through its Hydrocarbons business which represents 70% of group EBIT), which we believe stands to benefit from increased capex across the industry. As activity levels increase, strong operating leverage – driven by management's focus on controlling overhead costs and maintaining high staff utilisation – should drive earnings above consensus expectations. While WOR trades at a premium to peers based on consensus expectations (23.0 times forward earnings), this premium falls to a discount when adjusted for WOR's strong growth potential.

Vocus (VOC) – we lifted our overweight position in the telco following increased confidence in the outlook. We see an opportunity from the combination of new management, improving fundamentals, lack of sell-side focus and prevailing negative sentiment towards the stock. We expect cash flow conversion to improve, which makes an equity raising unlikely. The new management team is focused on integrating and simplifying its various acquired businesses, unifying its product offering and increasing customer product penetration. We remain confident in the longer-term revenue and margin opportunities and believe that the share price (at 11.5 times forward earnings) currently capitalises limited future growth.

Kathmandu (KMD) – we established a position in the outdoor adventure retailer in the quarter. Our investment thesis is premised on KMD's attractive category exposure, market share opportunities both in Australia and internationally, margin expansion opportunities and its attractive valuation (12-month forward P/E of 11.4 times). Furthermore, we hold a positive view of the OBOZ acquisition, which will accelerate KMD's expansion into footwear and the US wholesale market.

Key sales

GrainCorp (GNC) – we exited our position following the company's 1H18 result. Looking beyond the current crop season, we believe it will be difficult for GNC to realise the value of its infrastructure assets given their deep integration with operations, with the company unlikely to make significant changes to unlock this value in the near term. Furthermore, we believe the Malts business faces increased headwinds across its Australian operations, with competition creating both pricing and utilisation pressures.

Incitec Pivot (IPL) – we exited our holding in the quarter to pursue better opportunities elsewhere following a weakening outlook for IPL's key commodities, urea and diammonium phosphate (DAP). IPL's other business, explosives, enjoys a strong competitive position across most markets, but moderate risks have now emerged following WA contract losses announced in 1H18, with other key contracts coming up for renewal in the short term.

Ansell (ANN) – we reduced our position size following the stock's recent outperformance, but remain positive on the company. We continue to believe ANN can further improve operating leverage and increase market share, growing earnings above consensus expectations. Drivers include lower raw material costs, internal programs to increase operational efficiency, improved margins from new distributor agreements and a shift to higher-value products. ANN's relative valuation remains attractive, trading on a 12-month forward P/E of 17.7 times – a significant discount to its domestic peer group.

Key active overweights

Atlas Arteria (ALX) – we maintain a favourable view towards ALX based on its steep discount to intrinsic value and attractive, long-dated assets. ALX trades at an FY18 EV/EBITDA ratio of around 11 times, well below comparable asset transactions, which in part reflects the external management structure of the vehicle. Securityholders approved ALX's planned management internalisation in May, a change we believe will be highly value accretive. Not only have large fees leaked significant value over time, but the external structure and MQG's ownership stake – which was sold in December 2017 – represented a roadblock for any potential acquirer and, in our view, had prevented ALX's assets from being appropriately valued.

Seek (SEK) – our overweight position reflects our positive view towards the online recruitment company's products, following sustained and significant investment. We expect new product developments will deliver material new revenue opportunities and strengthen the existing businesses, both domestically and internationally. The structural growth of SEK's earlier stage markets should also support international growth, in our view, with synergies from recent acquisitions adding to earnings growth. The company's early stage businesses also contain latent value given its strong track record and the current earnings losses (FY18 earnings guidance implies early stage losses will detract 12% from group reported NPAT). SEK has a strong balance sheet (FY17 net debt to EBITDA 0.8 times) which will support further accretive acquisitions, including through lower risk increases to existing investments.

James Hardie (JHX) – we hold a positive view of both JHX's domestic (approximately 20% of earnings) and US operations (70% of earnings) as management pursues ongoing pricing, market share and plant optimisation initiatives. We expect resolution of US supply and manufacturing issues will assist in driving market share growth in coming periods, with EBIT margins set to improve due to a positive pricing environment and improving per unit operating costs. While representing less than 10% of the overall combined business value, we are supportive of JHX's purchase of EU-based Fermacell in the December quarter, given its market leading position and strong product offering.

ANZ Bank (ANZ) – we believe ANZ has made substantial progress in controlling its costs relative to peers. Consequently ANZ is well placed to continue to return capital to shareholders, particularly following the sale of its life insurance business. ANZ also has the ability to generate above system credit growth through its mortgage market share in NSW and via a potential rebound in institutional and small-to-medium enterprise lending (where lead indicators are encouraging). We view the company's discount to peers as attractive at a P/E multiple of 12.1 times and a price to book multiple of 1.3 times. In regards to the Royal Commission, we believe its narrow focus (macro-prudential policy is excluded) and broad scope (all financial services) dulls the potential impact to the sector.

Origin Energy (ORG) – we remain overweight the company as its recent initiatives to simplify the business unlocks value. Asset sales have substantially reduced balance sheet leverage and focused attention on its key assets – the Energy Markets business and APLNG project. The implied valuation of both the Energy Markets business and APLNG remains conservative, with an eventual demerger of both businesses or sale of APLNG the critical next step in crystallising this value.

Key active underweights

CSL (CSL) – we remain underweight CSL based on its forward valuation (32.9 times P/E and 23.1 times EV/EBITDA on a 12-month forward basis), which we believe more than captures the earnings outlook. Growth rates may also be more challenging to achieve in the longer term given new product growth across the industry will largely come from the more competitive recombinant portfolio sector, where CSL's plasma product economics and relative competitive advantage are less relevant.

National Australia Bank (NAB) – we do not hold a position in the bank, with our preferred banking exposures being ANZ Bank (ANZ), Commonwealth Bank (CBA) and Westpac (WBC). NAB's domestic business is a clear underperformer relative to peers, with pre-provision earnings stagnant over a number of years and significant catch-up investment required as evident by its move to accelerate costs and investment in FY18 along with a large ($755mn) restructuring charge. After a large 5-8% step-up in costs in FY18, NAB has guided to flat cost growth in FY19 and FY20, which we believe is unsustainable. We don't regard NAB's valuation – at 11.6 times forward earnings and 1.4 times book value – appealing when considering these headwinds.

BHP Billiton (BHP) – our underweight position reflects our cautious medium to longer term view towards BHP's commodity exposures, particularly iron ore and coal. We believe fundamentals point to lower prices as new supply comes onto the market and China's demand wanes from strong, stimulus-induced levels. Furthermore, the ability for BHP to support earnings through lower costs appears increasingly challenged – cost inflation is building (as evidenced in the 1H18 results) and capex will need to increase to more normal levels.

Wesfarmers (WES) – outside of the domestic Bunnings business, we maintain a negative view towards each of the conglomerate's divisions. In the short term, WES's decision to demerge Coles signals the supermarket's outlook remains challenged despite price investment. Following the demerger (expected to complete in FY19) WES becomes more skewed to Bunnings (50% of EBIT), its structurally challenged department stores and Officeworks (29% of EBIT). Officeworks and the department store industry (including discount department stores Target and Kmart) face increasing competition (e.g. Amazon) and excess physical store capacity. WES is also more exposed to its Industrials segment, which comprises cyclical, lower quality businesses.

Woolworths (WOW) – we remain underweight WOW, reflecting concerns across both the supermarket and discretionary retail businesses. Despite recent positive momentum in WOW's supermarket business (85% of group earnings), we hold a negative view of the sector due to a heightened competitive environment which will constrain future sales and margins. Furthermore, the outlook for Big W remains challenged, particularly with the threat of Amazon and excess discount department store capacity.

Market outlook

We believe fundamentals point to a strengthening earnings cycle for the Australian equity market, with upgrades to FY18 consensus estimates likely. Consensus sees Resources delivering high-single digit growth, with Industrials at mid-single digits and Financials at low-single digits.

Australian equities are priced modestly above their long-term average based on forward earnings estimates, though valuations remain attractive relative to alternatives such as fixed interest. The S&P/ASX 200 Index yields 4.4% on a 12-month forward basis (before franking) versus 2.6% from the Australian 10-year government bond yield.

At a global level, while an economic recovery outlook is driving valuations to elevated levels, we remain alert to economic and geopolitical risks, which include rising interest rates and China's real rate of growth.

We see significant value in certain sectors but believe others to be overvalued based on earnings and cash flow expectations. We remain overweight the Energy, Consumer

Discretionary and Industrials sectors, but are underweight Real Estate, Metals & Mining and Consumer Staples.

Sector allocation

	Portfolio %	Benchmark %	Active %
Consumer Discretionary	10.76	4.77	5.99
Consumer Staples	0.00	8.07	-8.07
Energy	8.52	5.74	2.79
Financials	34.44	33.12	1.32
Health Care	5.65	8.47	-2.82
Industrials	12.33	7.08	5.25
Information Technology	5.16	2.40	2.76
Materials	16.12	18.60	-2.48
Real Estate	0.00	7.48	-7.48
Telecommunication Services	4.48	2.25	2.23
Utilities	0.00	2.03	-2.03

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Commonwealth Bank of Australia	10.24	7.73	2.51
Westpac Banking	8.56	6.04	2.51
ANZ Banking	7.91	4.92	2.99
Origin Energy	4.03	1.06	2.97
Atlas Arteria	4.03	0.26	3.77

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	4.03	0.26	3.77
Seek	4.00	0.46	3.54
James Hardie Industries	3.89	0.61	3.28
Underweights			
CSL	0.00	5.25	-5.25
National Australia Bank	0.00	4.49	-4.49
BHP Billiton	2.57	6.56	-3.99

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	-0.79	-2.19	-1.94	-3.16
Distribution return	11.18	9.32	10.35	9.43

The Growth Return is measured by the movement in the Fund's units 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 outperform the S&P/ASX 200 Accumulation Index over rolling 3-year periods.
Recommended investment time frame	5 + years
Fund inception	December 1984
Fund size	A$9.97 mn as at 30 June 2018
APIR codes	JBW0005AU
Estimated management cost	1.65% p.a.
Buy/sell spread	+/- 0.15%

Applications and contacts

The Yarra Investment Fund is no longer available for new investment. The reinvestment of distributions is still allowed where an existing reinvestment instruction is in place.

Website www.yarracm.com

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