Yarra Ex-20 Australian Equities Fund

Total returns as at 30 September 2018

	From 25 June 2018^	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	Since inception % p.a.*
Yarra Ex-20 Australian Equities Fund	5.46	-0.58	6.52	21.73	13.80	8.24	8.27
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	0.76	-1.45	1.46	NA	NA	NA	NA
Excess return‡	4.70	0.87	5.05	NA	NA	NA	NA

^ Effective 25 June 2018 the Fund's investment strategy, name and benchmark was changed. Performance prior to 25 June 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.
Due to differences in business dates at month end, Fund performance returns are provided as at 27 September 2018, and benchmark performance returns are provided as at 30 September 2018. The monthly, quarterly and annual performance returns have been impacted.
* 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 June 2018, the benchmark is the S&P/ASX 300 ex S&P/ASX 20 Accumulation Index, replacing the S&P/ASX 300 Accumulation Index.
‡ Excess return: The difference between the Fund's return and the benchmark return.

Market review

The Australian share market rose in August as a relatively benign reporting season overshadowed divergent trends among stocks and sectors.

The S&P/ASX 300 ex S&P/ASX 20 Accumulation Index returned 1.5% in the quarter, taking its total return for 12 months to 15.9%. In comparison, the wider S&P/ASX 300 Index returned 1.5% for the quarter and 14.0% for the year.

In aggregate the Australian reporting season was in line with expectations, with 29% of companies beating expectations and 28% missing[1] across the ASX 200. FY19 earnings were revised 1% lower for companies that reported[2].

Information Technology (+13.0%) supported the index, with a number of securities generating strong returns. Top contributors included payment solutions provider Afterpay (APT, +92.0%), share registry company Computershare (CPU, +9.4%), online logistics company Wisetech Global (WTC, +41.2%) and electronic circuit board software provider Altium (+22.1%).

Energy (+7.7%) was another strong contributor as Brent crude increased by 4.9% to $US83 per barrel in the period and coal prices remained firm. Top contributors to the index's return included Santos Energy (+16.6%), Beach Energy (+22.6%) and WorleyParsons (WOR, +17.7%).

Conversely, Metals & Mining (-9.3%) declined sharply in the quarter. Top detractors were gold producers Newcrest (NCM, -10.3%), Evolution Mining (EVN, -23.4%) and Regis Resources (RRL, -25.9%) as gold price fell 4.9% to $US1,192 per ounce.

Utilities (-3.9%) also fell in the quarter in response to regulatory uncertainty, with regulated retail tariffs a real possibility that looms large over energy providers such as AGL Energy (AGL, -10.6%).

Portfolio review

Key contributors

TPG Telecom (TPM, overweight) – the company outperformed during the quarter after announcing a proposed merger of equals with Vodafone, with TPM to own 49.9% of the combined entity and Vodafone Holdings the remaining 50.1%. The merger, which is expected to become effective in 2019, consolidates the telco industry to three large players, with the merged entity (to be called TPG Telecom) becoming a strong challenger to incumbents Telstra (TLS) and Optus. TPG Telecom will have an enterprise value of $15bn, comprising debt of $4.1bn (2.2 times EBITDA) and equity of $10.9bn. We support the merger, which we expect will unlock significant synergies and provide the entity with the infrastructure, scale and balance sheet to maintain its disruptive nature. As a result we anticipate market share gains will accelerate across the Mobile, Fixed and Corporate divisions.

Vocus Group (VOC, overweight) – the telco outperformed after delivering a better-than-expected FY18 result. Management delivered FY18 EBITDA in line with expectations and guided to FY19 EBITDA of $350-370mn, 5% below forecasts at the midpoint, though cash conversion for the period increased from 68% to 110%. The improvement alleviated concerns that VOC would need to raise capital to avoid breaching its debt covenants. We remain positive towards the stock based on the combination of new management, improving fundamentals and quality of the asset base. The new management team is

[1] Source: JPMorgan Research.
[2] Source: UBS.

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 18.2 times forward earnings) currently capitalises only limited future growth.

Downer EDI (DOW, overweight) – the company outperformed after announcing it had won several new contracts in the quarter, including a five-year maintenance contract with Chevron Australia, a $160mn engineering and construction contract for the Numurkah Solar Farm in Victoria and a $120mn mining services contract with Cobar Management. At its result DOW met expectations for FY18 and gave upbeat commentary about FY19 as activity levels rebound. We continue to hold a positive view of the 2017 Spotless (SPO) acquisition and see encouraging signs of stability across DOW's legacy businesses, particularly in mining, which are still not fully reflected in market estimates. In our view DOW will more effectively manage SPO's core businesses with multiple potential cross-selling opportunities, and we believe DOW's decision to pivot more towards its infrastructure division, where a significant pipeline of new projects exists, provides an attractive future growth opportunity.

Key detractors

CSR (CSR, overweight) – the building materials company underperformed in response to concerns of a housing construction slowdown. In our view these concerns are overdone in regards to CSR, since the moderation is largely confined to the high-rise category; CSR's exposure is mostly to the single family home market which continues to enjoy strong underlying demand fundamentals. We remain overweight the stock based on three factors: a more positive outlook on the Building Products division than consensus as a result of an improved competitive landscape and market structure in bricks, management's strong operational expertise across all divisions (including Aluminium where earnings are being optimised through proactive hedging strategies and efficiency measures) and CSR's strong balance sheet – it is effectively debt free – which leave it well placed to pursue selective bolt-on acquisitions or capital management initiatives.

Eclipx Group (ECX, overweight) – the sales financing group declined in value following a disappointing FY18 trading update. Management downgraded FY18 NPATA by 11% versus earlier guidance and market expectations. The GraysOnline and Right2Drive businesses were responsible, with the core Australian and New Zealand Commercial businesses (70% of group earnings) generating earnings growth of 5%. We continue to hold a positive view towards ECX's core business: the company should continue to take market share (with high single-digit volume growth and stable pricing) and there is a large cost-out opportunity from upgrading existing systems. Additionally, ECX is well positioned to benefit from the major banks pulling back from lending in this industry. Subsequent to the downgrade the company received a takeover offer from fleet peer, SGFleet. The logic for industry consolidation is compelling, with significant synergies available to the merged entity. With the stock trading at a P/E of 10.0 times on a 12-month forward basis – a material discount to its peers – we continue to hold the position.

James Hardie (JHX, overweight) – the building materials company underperformed after delivering maiden FY19 earnings guidance below market expectations in its 1Q19 results. Management guided to FY19 net profit of $US300-340mn, 4% below consensus forecasts at the midpoint. Around half of the downgrade came from partially one-off drivers, including higher US input costs and the refurbishment of the Fermacell plant, however the other half was due to reduced conviction in the growth outlook for its US-based business. Nevertheless, we remain confident about the market share outlook in the medium term, with primary demand growth to accelerate as JHX wins business following resolution of US supply and manufacturing issues. Furthermore, JHX now trades at a more supportive 18.8 times forward earnings, a 10% discount to its Industrial peers.

Key purchases

Kathmandu (KMD) – we established a position in the outdoor adventure retailer during 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 12.1 times). Furthermore, we hold a positive view of the OBOZ acquisition, which will accelerate KMD's expansion into footwear and the US wholesale market.

Eclipx (ECX) – we took a period of underperformance after a disappointing FY18 trading update as an opportunity to increase our position size in the sales financing group. We continue to hold a positive view towards ECX's core business: the company should continue to take market share (with high single-digit volume growth and stable pricing) and there is a large cost-out opportunity from upgrading existing systems. Additionally, ECX is well positioned to capitalise on the major banks pulling back from lending in this industry. Subsequent to increasing the position size, the company received a takeover offer from fleet peer, SGFleet. The logic for industry consolidation is compelling with significant synergies available to the merged entity. The stock is trading on a P/E of 10.0 times on a 12-month forward basis – a material discount to its peers.

Key sales

CSR (CSR) – we reduced our overweight position due to our view of the available upside from current levels, but we remain positive towards the company. In our view concerns over a housing construction slowdown are overdone in regards to CSR, since the moderation is largely confined to the high-rise category; CSR's exposure is mostly to the single family home market which continues to enjoy strong underlying demand fundamentals. We remain overweight the stock based on three factors: a more positive outlook on the Building Products division than consensus as a result of an improved competitive landscape and market structure in bricks, management's strong operational expertise across all divisions (including Aluminium where earnings are being optimised through proactive hedging strategies and efficiency measures) and CSR's strong balance sheet – it is effectively debt free – which leave it well placed to pursue selective bolt-on acquisitions or capital management initiatives.

Independence Group (IGO) – we reduced our position in the nickel-gold miner during the quarter in favour of increasing our holding in Alumina (AWC), where we have higher conviction in the commodity outlook. That being said, we remain overweight IGO based on our positive view of the Nova and Tropicana assets – two world-class reserves – which support an increasing production profile (Jaguar was divested during the June quarter for $73mn). After a slower than expected start-up from Nova, we believe its issues have been largely resolved, with increasing production and higher commodity prices supporting material cash flow over the medium to long-term. Meanwhile, we expect higher grades and production at a lower cost from Tropicana. IGO's balance sheet remains well capitalised, with net debt of $4mn.

Iluka Resources (ILU) – we reduced the position size in the mineral sands producer as part of our decision to reduce resources exposure in the portfolio. However, we remain overweight the stock as we continue to see a solid demand environment for zircon, exceeding current production levels and adding tightness to the market given the low inventory levels of producers. We believe ILU will generate material earnings growth from its high-quality assets and dominant position in the zircon and titanium dioxide feedstock markets. Mineral sands prices, in our view, will continue to revert to sustainably higher levels now that destocking has largely run its course.

Key active overweights

TPG Telecom (TPM) – our overweight position is based on a positive view of the proposed merger with Vodafone. We expect the combined entity to unlock significant synergies and harness its infrastructure, scale and balance sheet to disrupt incumbents Telstra (TLS) and Optus through its lower-cost structure. As a result, we anticipate market share gains will accelerate across the Mobile, Fixed and Corporate divisions. Furthermore, we expected the combined entity will now be able to acquire 5G spectrum at a lower cost in the upcoming auction.

James Hardie (JHX) – we hold a positive view of both JHX's domestic (approximately 20% of earnings) and US operations (approximately 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 to the top-end of the 20-25% target range in FY19 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 2017 quarter, given its market leading position (75% category share of fibre gypsum market) and options for growth.

Star Entertainment (SGR) – we are overweight the casino company because 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. Further, we believe SGR's valuation is attractive, with the stock trading at 16.9 times versus peer Crown Resorts (CWN) at 21.2 times.

Key active underweights

Aristocrat Leisure (ALL) – we are underweight ALL on the grounds that consensus fully captures the company's growth outlook, with the market fully factoring in the opportunity to derive more revenue from its annuity-style leasing of electronic gaming machines. At a forward P/E of 19.6 times, however, we do not believe the market fully accounts for risks in the ALL's legacy business (outright sales), which is a volatile segment that to a large extent relies on new casino openings, and we question the sustainability of the Digital division's earnings growth following the acquisition of Big Fish Games in January 2018. As a result, we see better relative opportunities elsewhere.

Goodman Group (GMG) – our underweight position reflects our more cautious outlook for development earnings and GMG's premium share price valuation of 20.2 times earnings and 2.1 times net tangible assets. We see the outlook for development earnings – which account for approximately 40% of total EBITDA – moderating with commencements beginning to fall. As a result, we are sceptical that development work in progress (WIP) can be maintained at current elevated levels ($3.5-3.6bn in FY18) over the medium-term. Lastly, we believe the tailwind from Amazon's entry into the Australian market (i.e. generating more demand for warehousing space) is overblown in the context of GMG's local business.

Sydney Airport (SYD) – while we have a positive view towards the business given the strong barriers to entry and a supportive demand backdrop (SYD captures 40% of inbound air passengers to Australia), we see better opportunities elsewhere. SYD trades at 18.0 times forward EV/EBITDA and is sensitive to higher interest rates, which we remain wary of at this point of the cycle.

Market outlook

We believe fundamentals point to a strengthening earnings cycle for the Australian equity market. Consensus sees Resources and Industrials ex-Financials driving high single-digit earnings growth, moderated by more modest earnings growth in Financials.

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 4.6% on a 12-month forward basis (before franking) versus 2.7% 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, including 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 are overweight the Communication Services, Consumer Discretionary and Industrials sectors, but are underweight Real Estate, Consumer Staples and Utilities.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	18.26	3.67	14.59
Consumer Discretionary	15.84	10.01	5.83
Consumer Staples	0.00	5.54	-5.54
Energy	8.89	7.06	1.83
Financials	10.08	12.55	-2.46
Health Care	8.14	7.63	0.51
Industrials	14.98	11.63	3.35
Information Technology	2.45	5.38	-2.93
Materials	19.87	17.22	2.65
Real Estate	0.00	14.97	-14.97
Utilities	0.00	4.33	-4.33

Top 5 holdings

	Portfolio %	Benchmark %	Active %
TPG Telecom	8.16	0.39	7.77
James Hardie Industries	6.87	1.25	5.61
Santos	6.01	1.72	4.28
Seek	5.78	0.98	4.80
Star Entertainment Group	5.72	0.58	5.15

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
TPG Telecom	8.16	0.39	7.77
James Hardie Industries	6.87	1.25	5.61
Star Entertainment Group	5.72	0.58	5.15
Underweights			
Aristocrat Leisure	0.00	2.44	-2.44
Goodman Group	0.00	2.24	-2.24
Sydney Airport	0.00	2.09	-2.09

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	18.22	10.44	5.33	5.40
Distribution return	3.51	3.36	2.91	2.87

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 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	Pooled Fund A$29.42 mn as at 30 September 2018	
APIR code	JBW0052AU	
Estimated management cost	0.95% p.a	
Buy/sell spread	+/- 0.15%	
Platform availability	Asgard BT Wrap BT Panorama Macquarie Wrap Consolidator	Macquarie Wrap Accumulator Hub24

Applications and contacts

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

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Disclaimers

The Yarra Ex-20 Australian Equities Fund is substantially invested in the Yarra Ex-20 Australian Equities Pooled Fund ('Pooled Fund'). References in this document to the underlying assets or investments of the Funds generally relate to the assets held in the Pooled Fund.

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