Investment Commentary
Month to 30 November 2018

Yarra Ex-20 Australian Equities Fund

Gross returns as at 30 November 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	-10.74	-6.37	-16.00	-4.02	5.72	5.29	7.26
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	-9.30	-2.95	-11.30	NA	NA	NA	NA
Excess return (before fees)‡	-1.44	-3.42	-4.70	NA	NA	NA	NA

Past performance is not a reliable indicator of future performance. Taxes payable by investors have not been taken into account. The figures shown have been provided for illustrative purposes – they are unaudited and subject to change. The total returns shown are gross of all fees, meaning they do not reflect the deduction of any investment management fees which would reduce returns and assume reinvestment of all distributions. Investment in the fund is not available on a fee free basis and this should be factored into any analysis of past performance.

Net returns as at 30 November 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	-11.11	-6.44	-16.20	-5.11	4.41	3.97	5.90
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	-9.30	-2.95	-11.30	NA	NA	NA	NA
Excess return (after fees)‡	-1.80	-3.49	-4.90	NA	NA	NA	NA

Past performance is not a reliable indicator of future performance. Taxes payable by investors have not been taken into account. The figures shown have been provided for illustrative purposes – they are unaudited and subject to change. The total returns shown are prepared on an exit to exit basis – they include all ongoing fees and expenses and assume reinvestment of all distributions.

^ **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.
* 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

Weaker commodity prices and a stronger Australian dollar sent Australian equities lower in November, with the local index underperforming global markets.

The S&P/ASX 300 Ex-20 Accumulation Index declined 3.0% in November, underperforming the S&P/ASX 200 Accumulation Index which fell 2.2% in the month. In comparison, the MSCI World Index and the S&P500 lifted by 1.2% and 2.0% respectively.

While 10 of 11 sectors fell in the month, the worst detractors from the benchmark's return were Energy (-10.4%) and Metals & Mining (-3.2%). All Energy stocks fell in value in response to Brent crude dropping 21% to $US59 per barrel during the month, with the worst performers including Santos (STO, -16.9%), Beach Energy (BPT, -13.4%), FAR (FAR, -44.8%), Washington H. Sol Pattinson (SOL, -8.2%) and WorleyParsons (WOR, -9.5%). In Metals & Mining, the worst performers included Bluescope Steel (BSL, -21.9%) and Alumina (AWC, -12.5%).

Elsewhere, Consumer Discretionary (-4.3%) also underperformed as company updates and weaker-than-expected retail sales data revealed a softer consumer trading environment. The worst performers included Star Entertainment (SGR, -7.6%), Bapcor (BAP,-10.1%) and Breville (BRG, -10.7%).

Information Technology (+1.0%) was the only sector to rise for the month. Top performers included high P/E stocks Afterpay (APT, +15.5%), Appen (APX, +30.6%), Wisetech Global (WTC, +16.5%), TechnologyOne (TNE, +16.0%) and NEXTDC (NXT, +9.7%).

Portfolio review

Key contributors

Lend Lease (LLC, underweight) – the property developer underperformed during the month after announcing a $350mn after-tax provision to its Engineering & Services business. The provision was driven by lower productivity in the NorthConnex project in Sydney, excessive wet weather, access issues and remedial work from defective design in other projects. We remain underweight the company for a number of reasons: further write-downs on other troubled contracts are likely, the balance sheet appears stretched in the short term (with gearing at the top of the 10-20% range) and FY19 consensus earnings expectations appear overly optimistic, relying on a heavy transactional period in 2H19.

Seek (SEK, overweight) – the online recruitment company outperformed after affirming its FY19 earnings guidance at its AGM during the month, alleviating concerns about slowing domestic jobs growth. Management expects revenue growth of 16-20% and EBITDA growth of 5-8% for FY19, which we believe the company is well positioned to achieve. We remain overweight the stock, with product developments set to deliver 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, particularly in China.

Eclipx (ECX, overweight) – the sales financing group outperformed after receiving a merger proposal from McMillan Shakespeare (MMS) during the month and meeting full-year guidance in its FY18 result. The offer comprises $0.46 cents per share in cash and 0.1414 MMS shares for every ECX share, which implied a 23% premium to ECX's last traded price prior to the announcement. However, following a decline in MMS's share price the offer equated to $2.46 per share at month-end, only marginally above SG Fleet's (SGF) earlier offer of $2 cash and 0.15 of its shares for every ECX share. We remain overweight the stock based on the potential for a higher takeover bid and our positive view of ECX's core business. The company should take market share (with high single-digit volume growth and stable pricing) and has a large cost-out opportunity from upgrading existing systems.

Key detractors

Bluescope Steel (BSL, overweight) – the steel producer underperformed despite reiterating 1H19 earnings guidance at its AGM. The market was instead focused on a contraction of steel spot spreads during the month which, if they persist, could create an earnings headwind for 2H19. While BSL's earnings remain subject to volatile commodity prices, its recent cost-reduction programs and shifting business mix provides confidence its earnings are more resilient than in previous cycles, factors we believe are underappreciated by the market. More broadly, we remain overweight BSL due to its high-quality assets both domestically and internationally, its strong balance sheet, capital management initiatives (with a $250mn buy-back recently announced) and a supportive valuation at 6.4 times forward earnings. In the long-term, we expect BSL to remain soundly profitable and cash-flow positive, even when the cycle troughs.

James Hardie (JHX, overweight) – the building materials company underperformed after delivering a worse-than-expected 1H19 result. Management downgraded FY19 net profit to $280-320mn (-6.3% at the mid-point) as a result of a weaker US volume and margin outlook. While FY19 guidance was underwhelming, we remain confident about the market share outlook in the medium to long-term; we expect primary demand growth to accelerate as JHX wins business following resolution of US supply and manufacturing issues. Secondly, JHX should be able to offset margin pressure through product re-pricing (which it does annually). Lastly, JHX now trades at a more supportive 15.1 times forward earnings, an attractive discount to the ASX Industrials sector.

Santos (STO, overweight) – the oil & gas producer underperformed as Brent crude fell 21% to $US59 per barrel. We remain overweight the stock based on a positive view of its recent Quadrant acquisition and the company's strong free cash flow profile. The Quadrant acquisition, which was approved by the ACCC during the month, was made at an attractive price (4.4 times trailing EBITDAX), did not require a capital raising and will be highly EBITDAX accretive. The acquisition also diversifies STO's portfolio across Australia (reducing its reliance on East Coast gas), with the company consolidating its position in the Western Australian gas market at around a 36% combined market share. STO remains significantly cash flow positive at current oil price levels, with the balance sheet expected to deleverage to less than 30% by the end of 2019.

Key purchases

Sydney Airport (SYD) – we established a position in the airport owner and operator in the month, taking advantage of the recent sell-off. In our view SYD is set to benefit from a supportive demand backdrop (the airport captures approximately 40% of Australia's inbound air passengers) and with strong barriers to entry as Sydney's only international airport. Higher prices and robust passenger numbers support strong revenue growth which, when combined with its high operating leverage, enables SYD to grow its dividend by approximately 10% per annum on a five-year compound annual growth rate.

WorleyParsons (WOR) – we increased our position in the engineering construction firm during the month following recent underperformance. We expect WOR to benefit from its exposure to oil & gas (primarily through its Hydrocarbons business), 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. We also hold a positive view of WOR's recent Jacobs' ECR acquisition, which makes sense strategically and is 20% EPS accretive in FY18. While WOR trades at a premium to peers based on consensus expectations (17.2 times forward earnings), this premium falls to a discount when adjusted for WOR's strong growth potential.

oOH! Media (OML) – we increased our position size in the outdoor media company during the month. We support the recent Adshel acquisition, given its mid-single digit earnings accretion, strong strategic rationale, and clear revenue and cost synergies. More broadly we hold an optimistic view of the sector: outdoor advertising is expanding its share of the total advertising market (currently 5%) supported by increased penetration of digital boards. Given OML's high gross margins and its largely fixed cost base, we expect the positive revenue outlook will support strong medium-term earnings growth.

Key sales

Clydesdale (CYB) – we exited our position in the UK bank following its FY18 result in the month. While FY18 earnings were only modestly below expectations, disappointing FY19 guidance invalidated our investment thesis. CYB guided to net interest margins (NIMs) of 160-170 bps, well below consensus of 179 bps, due to a contraction in the recently acquired Virgin Money portfolio. The main driver was customers rolling off Virgin Money's higher margin back book to the lower margin front book, which we expect will cause ongoing pressure. In the context of deteriorating fundamentals, a weaker industry structure than we had perceived and ongoing Brexit uncertainty, we don't find the stock attractive despite appearing cheap at 0.8 times tangible book value and 8 times forward earnings.

Independence Group (IGO) – we exited our position in the nickel & gold miner during the month. While we maintain a positive view towards the company's Nova and Tropicana assets – two world-class reserves – we believe there are better opportunities elsewhere, and used the funds to establish positions in WorleyParsons (WOR) and TPG Telecom (TPM) during the month. In Metals & Mining, Alumina (AWC) remains our preferred stock due to our higher confidence in the commodity's outlook.

Vocus (VOC) – we reduced the position size in the telco following recent outperformance, but remain overweight as we continue to see further upside. Our positive view is premised on the combination of new management, improving fundamentals and quality of the asset base. 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.

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 will 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 expect the combined entity will now be able to acquire 5G spectrum at lower cost in the upcoming auction.

Atlas Arteria (ALX) – we maintain a favourable view towards ALX based on the continued strong operational performance of its attractive, long-dated assets and its discounted valuation of 11 times EV/EBITDA, which in part reflects the complicated ownership structures of its assets. Securityholders approved the internalisation of ALX's management in May, a change we believe is a significant step towards ultimately simplifying the ownership structures of ALX's two key assets and, in doing so, fully reflecting their intrinsic value. We believe ALX now has a credible strategy for achieving this goal in the near term which will result in significant upside.

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 the resolution of US supply and manufacturing issues will assist in driving market share growth in coming periods, with EBIT margins set to improve over the medium term due to a more positive pricing environment and improving per unit operating costs.

Key active underweights

Goodman Group (GMG) – our underweight position reflects our more cautious outlook for development earnings and GMG's premium share price valuation of 19.6 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.

Newcrest (NCM) – our underweight position is predicated on the gold miner's concentrated assets in Cadia and Lihir, premium valuation and an increasing capex profile. Both capex and M&A are likely to increase as the company seeks to gain exposure to five tier-one assets by 2020. The stock trades at an EV/EBITDA multiple of 7.1 times on a 12-month forward basis, which in our view does not reflect significant risks (seismicity and PNG sovereign risk) and is expensive relative to peers with more attractive organic growth, including OceanaGold (OGC) and Saracen Minerals (SAR) which trade at 4.9 times and 6.4 times respectively.

QBE Insurance (QBE) – our underweight position in the insurer is based on several factors. Firstly, we believe the outlook for gross written premiums (GWP) is difficult as QBE prioritises price over volume, with the company's implied guidance below consensus expectations over the next two years. Secondly, we expect higher earnings volatility following QBE's recently announced reinsurance program, which costs $125mn less but increases the company's exposure to medium-sized events. Thirdly, QBE is now more reliant on investment income (40% of insurance profit) for growth, where the outlook is now less favourable. We do not see the company's valuation (12-month forward P/E of 12.5 times) as attractive when considering these headwinds.

Market outlook

We believe fundamentals point to a solid earnings cycle for the Australian equity market. Consensus sees Resources driving mid-single-digit earnings growth, moderated by lower earnings growth from Industrials and Financials.

Australian equities are priced in line with long-term averages based on forward earnings estimates, though valuations remain attractive relative to alternatives such as fixed interest.

The S&P/ASX 200 Index yields 5.1% on a 12-month forward basis (before franking) versus 2.6% from the Australian 10-year government bond yield.

We remain alert to economic and geopolitical risks, including lower house prices domestically, rising interest rates in the US, the impact of tariffs 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 Financials.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	17.03	3.34	13.69
Consumer Discretionary	16.29	9.76	6.53
Consumer Staples	0.00	5.55	-5.55
Energy	10.85	6.56	4.29
Financials	7.05	12.46	-5.41
Health Care	8.23	7.66	0.57
Industrials	20.50	11.83	8.67
Information Technology	0.33	5.30	-4.97
Materials	17.11	17.54	-0.43
Real Estate	0.00	15.48	-15.48
Utilities	0.00	4.52	-4.52

Top 5 holdings

	Portfolio %	Benchmark %	Active %
TPG Telecom	6.70	0.37	6.34
Atlas Arteria	6.68	0.66	6.02
James Hardie Industries	6.61	1.06	5.55
Seek	6.31	0.97	5.34
Star Entertainment Group	5.92	0.54	5.38

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
TPG Telecom	6.70	0.37	6.34
Atlas Arteria	6.68	0.66	6.02
James Hardie Industries	6.61	1.06	5.55
Underweights			
Goodman Group	0.00	2.46	-2.46
Newcrest Mining	0.00	2.37	-2.37
QBE Insurance Group	0.00	2.32	-2.32

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	-7.85	1.33	1.17	3.15
Distribution return	2.74	3.08	2.80	2.75

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$23.80 mn as at 30 November 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.

Website www.yarracm.com

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