YARRA
CAPITAL MANAGEMENT

Investment Commentary
Quarter to 31 December 2018

Yarra Investment Fund

Gross returns as at 31 December 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^	-2.65	-12.61	-7.78	4.45	4.93	9.48	NA
S&P/ASX 200 Accumulation Index†	-0.12	-8.24	-2.84	6.68	5.63	8.99	NA
Excess return (before fees)‡	-2.54	-4.37	-4.94	-2.23	-0.70	0.49	NA

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

Net returns as at 31 December 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^	-2.79	-12.97	-9.28	2.75	3.23	7.70	9.92
S&P/ASX 200 Accumulation Index†	-0.12	-8.24	-2.84	6.68	5.63	8.99	NA
Excess return (after fees)‡	-2.67	-4.74	-6.44	-3.93	-2.41	-1.29	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.

* 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 share market fell alongside global equities in the final quarter of 2018 as macroeconomic factors dominated returns.

The S&P/ASX 200 Accumulation Index declined 8.2% in the three months to 31 December 2018, taking its total return for the year to -2.8%. Australian shares outperformed global indices, with the MSCI World Index and the S&P 500 dropping by 13.0% and 13.5% respectively in the quarter.

The VIX "fear index" more than doubled during the quarter to 25.4 points as concerns rose that higher interest rates, trade tariffs and growing cost inflation were harming global economic growth. The US Federal Reserve nevertheless raised interest rates by 0.25% to a target range of 2.25-2.5% in December and gave a less dovish outlook than expected. In Australia, third-quarter GDP was below expectations, rising 2.8% y/y versus the RBA's forecast of 3.5% growth.

While all sectors declined in the period, the worst performers were Energy (-21.3%) and Communication Services (-14.7%). The former dropped in unison with the oil price, with Brent Crude down 34.0% to $US54 per barrel. The latter underperformed after the ACCC expressed concerns about the proposed merger between TPG Telecom (TPM, -24.4%) and Vodafone and as weakness in the Australian advertising market impacted the Media (-31.4%) industry.

Conversely, the Banking sector (-6.0%) modestly outperformed as a relatively strong performance from Commonwealth Bank (CBA, +1.4%) offset weakness from ANZ Bank (ANZ, -10.6%), National Australia Bank (NAB, -10.0%) and Westpac Bank (WBC, -7.1%). The industry's chief executives faced the Financial Services Royal Commission and shareholders voted against remuneration reports, with only CBA escaping a first strike out of the big four.

Metals & Mining (-2.5%) provided the most support, driven by Gold miners (+20.2%) and large cap miners BHP Billiton (BHP, -1.2%) and Rio Tinto (RIO, -0.4%). In Gold, all constituents rose as the gold price climbed 7.5% to $US1,282 per ounce, while BHP and Rio both benefited from their share buy-back programs and the iron ore price rallying 5.1% to $US73 per tonne .

Elsewhere, Utilities (-3.1%) and REITs (-1.9%) outperformed as investors increased their allocations to defensive equities. Top performers included AGL Energy (AGL, +5.6%) in the former and Goodman Group (GMG, +4.0%), GPT Group (GPT, +4.9%) and Dexus (DXS, +3.1%) in the latter.

Portfolio review

Key contributors

Commonwealth Bank (CBA, overweight) – the bank outperformed after delivering a 1Q19 result in line with consensus expectations despite a challenging operating environment. Cash NPAT was $2.5bn, with operating income 1% higher than the quarterly average in the prior half. The result sets up CBA to produce a 1H19 result ahead of expectations, providing it can avoid regulatory and conduct charges in the second quarter. We continue to believe CBA is well placed to take advantage of stable net interest margins (with CBA's rate rise in early September alleviating this pressure), low to mid-single digit credit growth and ongoing cost reductions. Notwithstanding the uncertainty and potential risks posed by the Financial Services Royal Commission, we believe CBA will be able to deliver low to mid-single digit earnings growth, will commence returning capital within the next 12 months and that the valuation – at 13.0 times forward earnings per share and with a 6.0% fully franked dividend yield – overstates the medium to long-term earnings risks.

ResMed (RMD, overweight) – the sleep apnea device maker outperformed during the quarter after delivering a solid 1Q19 result and announcing a series of bolt-on acquisitions. EPS was 4% ahead of consensus for the period, driven by strong revenue growth (+13%) as the company took market share in Masks in the Americas and Devices in the rest of the world. The acquisitions, which included MatrixCare for $US750mn and Propeller Health for $US225mn, build out RMD's offering in connected health care solutions alongside Brightree. The result provides us with confidence that RMD is well placed to beat FY19 earnings expectations. While the market is beginning to capture the company's appealing growth characteristics, we see further upside as earnings growth rates accelerate over the next one to two years, with benefits accruing from a positive product cycle in the flow generator and mask segments.

Woodside Petroleum (WPL, underweight) – the oil and gas producer declined alongside the oil price, with Brent Crude falling 34.0% during the quarter to $US54 per barrel. We remain underweight the stock based on WPL's unsustainable production profile, a dividend payout ratio of 80% that is incompatible with the requirement to replace depleting assets and an unappealing valuation (11.7 times forward P/E and 5.1 times EV/EBITDA). While we hold a positive view of Chinese demand for LNG, we believe Santos (STO) is a more attractive exposure to this thematic at this time.

MYOB (MYO, overweight) – the accounting software company outperformed after receiving a takeover proposal from private equity group KKR during the quarter at $3.70 per share, which was later revised up to $3.77 per share before being reduced to $3.40 per share following due diligence and the equity market sell-off. MYO agreed to the revised offer in the absence of a superior proposal, subject to an independent expert's report recommending the transaction. KKR made the initial offer after acquiring a 19.9% stake in MYO, with 17.6% purchased from Bain Capital Abacus Holdings at $3.15 per share. While we reduced our overweight position following the initial bid, we continue to hold a small position in the stock given the potential for a competing bid, with MYO able to solicit competing proposals until February 2019, and the stock now trading at a material discount to the offer.

Lend Lease (LLC, underweight) – the property developer underperformed during the quarter 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 look overly optimistic, relying on a heavy transactional period in 2H19.

Key detractors

WorleyParsons (WOR, overweight) – the engineering services company underperformed in response to the Brent Crude oil price declining 34.0% to $US54 per barrel and due to a shortfall in the retail component of its equity raising to part fund its $US3.3bn acquisition of Jacobs ECR. Retail shareholders took up only 51% of their entitlements with the shortfall taken up by sub-underwriters. We remain overweight the stock based on our positive view of the Jacobs acquisition and WOR's existing hydrocarbons business, where we see the potential for significant upside. In our view the acquisition is strategically sound, with 20% EPS accretion in FY18 on a pro-forma basis before cost synergies. In hydrocarbons, which comprise 39% of the combined business following the transaction, the recovery remains on track with activity levels robust and client behaviour unchanged.

James Hardie (JHX, overweight) – the building materials company underperformed after delivering a worse-than-expected 1H19 result. As part of the 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 is underwhelming, we remain confident about JHX's market share outlook over the medium to long-term; we expect primary demand growth to accelerate as the company 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.

TPG Telecom (TPM, overweight) – the telco underperformed after the ACCC raised concerns about its proposed merger with Vodafone. The regulator laid out a statement of issues, including that it would substantially lessen competition by removing TPM as an aggressive competitor in Mobile and that Vodafone may become an effective fixed broadband reseller. While the update is disappointing, we believe the issues can be addressed and that the merger ultimately will be delayed, not blocked. 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.

Santos (STO, overweight) – the oil and gas producer underperformed as Brent crude fell 34.0% to $US54 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 quarter, 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 likely to deleverage to less than 30% by the end of 2019.

Origin Energy (ORG, overweight) – the energy company underperformed in response to Brent crude falling 34.0% to $US54 per barrel and uncertainty over retail electricity prices, with intense regulatory pressure and the potential introduction of a default pricing offer expected to impact retail margins in FY20. We remain overweight ORG; with the stock trading at 9.4 times forward earnings we believe the implied valuation of both the Energy Markets business and APLNG remains conservative. In our view an eventual demerger of both businesses or the sale of APLNG remains the critical next step in crystallising this value.

Key purchases

Sydney Airport (SYD) – we established a position in the airport owner and operator during the quarter. 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.

Transurban (TCL) – we increased our position in the toll road operator during the quarter, increasing the portfolio's exposure to defensive equities. TCL has a strong growth outlook (with a number of new project and expansion plans), asset diversification and offers an attractive risk adjusted total return. If inflation returns, its compounding effect will provide a meaningful offset to higher discount rates (on a net present value basis), given the majority of TCL's revenue growth is linked to CPI.

NEXTDC (NXT) – we established a position in the data centre operator during the quarter. In our view, the business is structurally set to benefit from the increasing adoption of cloud technology and is accelerating its expansion to meet the demands of its clients. To this end, the company is currently building three new data centres which will support significant medium to longer term earnings growth. The outlook for NXT appears attractive given the company's growth profile, infrastructure-like characteristics at maturity, and supportive valuation.

Key sales

Macquarie Group (MQG) – we exited our position in the investment bank during the quarter following strong outperformance. We remain positive on the outlook given MQG's robust capital position and apparent success in avoiding the majority of issues from the Financial Services Royal Commission. However, we believe this is fully captured in MQG's valuation at this time, with the stock trading at 12.3 times forward earnings and 2.0 times book value. Further, MQG is leveraged to global economic growth, which appears to be slowing following a strong run.

Computershare (CPU) – we exited our position in the share registry company early in the quarter following recent outperformance. We believe the tailwind of rising interest rates – which CPU benefited from in FY18 – will not persist to the same degree in FY19 and are now captured in expectations. While management has been successful with its cost-out program and is accelerating growth in its mortgage servicing business, in our view the upside is captured by consensus, with the stock trading at a 12-month forward P/E of 15.8 times.

Clydesdale (CYB) – we exited our position in the UK bank in the quarter following the release of its FY18 result. 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 uncertainty from Brexit, we do not find the stock attractive despite appearing cheap at 0.8 times tangible book value and 8 times forward earnings.

Key active overweights

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 is in part due to the complicated ownership structures of its assets. Securityholders approved the management internalisation of ALX 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.

ANZ Bank (ANZ) – we believe ANZ has made substantial progress in controlling its costs relative to peers and is consequently well placed to continue to return capital to

shareholders, particularly following the sale of its life insurance business. Notwithstanding the uncertainty and potential risks posed by the Financial Services Royal Commission, ANZ has the ability to generate above system credit growth through its mortgage market share and via a potential rebound in institutional and small-to-medium enterprise lending. We view the company's discount to peers as attractive at a P/E multiple of 10.3 times and a price to book multiple of 1.1 times.

Seek (SEK) – our overweight position reflects our positive view towards the online recruitment company's products following a period of sustained and significant investment. We expect product developments will 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. The company's early stage businesses also contain latent value when considering SEK's strong track record and current earnings losses. SEK has a strong balance sheet (FY18 net debt to EBITDA 1.2 times) which can support further accretive acquisitions, including through lower risk increases to existing investments.

Key active underweights

CSL (CSL) – we remain underweight CSL based on its forward valuation (28.2 times P/E and 19.8 times EV/EBITDA on a 12-month forward basis), which we believe appropriately captures the current earnings outlook. The growth outlook for CSL's key plasma products remains robust with the company continuing to strengthen its relative market position through long-term investment in capacity, product innovation and collection centres.

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 company's FY18 results) and capex will need to increase to more historic levels.

National Australia Bank (NAB) – we do not hold a position in the bank, with our preferred banking exposures being Commonwealth Bank (CBA), Westpac (WBC) and ANZ Bank (ANZ). 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 together 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 do not regard NAB's valuation – at 10.2 times forward earnings and 1.2 times book value – as being appealing when considering these headwinds.

Market outlook

We believe fundamentals including employment, population and GDP growth point to a robust Australian economy. The outlook for company earnings appears strong, supported by Resources and select Industrials.

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 2.3% from the Australian 10-year government bond yield.

Macroeconomic risks persist, however, and require careful monitoring. 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 our earnings and cash flow expectations. We are most overweight stocks within the Industrials, Communication Services and Energy sectors, but are underweight Real Estate, Metals & Mining and Consumer Staples.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	9.31	3.50	5.81
Consumer Discretionary	7.85	6.32	1.53
Consumer Staples	0.00	5.75	-5.75
Energy	9.49	5.40	4.09
Financials	34.01	32.63	1.38
Health Care	4.82	8.75	-3.93
Industrials	17.45	7.96	9.49
Information Technology	1.67	2.11	-0.44
Materials	12.27	18.19	-5.92
Real Estate	0.00	7.36	-7.36
Utilities	0.00	2.02	-2.02

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Commonwealth Bank of Australia	11.65	8.46	3.19
Westpac Banking	8.60	5.71	2.89
ANZ Banking	8.02	4.70	3.32
Atlas Arteria	4.87	0.27	4.59
Transurban	4.08	2.02	2.06

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	4.87	0.27	4.59
ANZ Banking	8.02	4.70	3.32
Seek	3.68	0.39	3.29
Underweights			
CSL	0.00	5.56	-5.56
BHP Billiton	1.69	6.69	-5.00
National Australia Bank	0.00	4.36	-4.36

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	-18.74	-6.03	-6.80	-1.84
Distribution return	9.46	8.78	10.03	9.54

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$8.14 mn as at 31 December 2018
APIR codes	JBW0005AU
ARSN code	090 047 662
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.

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