YARRA CAPITAL MANAGEMENT

Investment Commentary
Month to 28 February 2019

Yarra Australian Equities Fund

Gross returns as at 28 February 2019

	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Australian Equities Fund	6.79	7.64	3.43	11.43	6.58	11.18	10.93
S&P/ASX 200 Accumulation Index†	5.98	9.95	7.05	12.91	7.30	11.12	9.37
Excess return (before fees)‡	0.81	-2.31	-3.63	-1.48	-0.71	0.07	1.56

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 28 February 2019

	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Australian Equities Fund	6.71	7.39	2.45	10.38	5.58	10.14	9.93
S&P/ASX 200 Accumulation Index†	5.98	9.95	7.05	12.91	7.30	11.12	9.37
Excess return (after fees)‡	0.73	-2.56	-4.60	-2.53	-1.72	-0.98	0.56

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 Australian Equities Fund: July 1996

† The benchmark for the Yarra Australian Equities Fund has been amended since the Fund's inception. Effective 28 February 2008 the benchmark is the S&P/ASX 200 Accumulation Index, replacing the S&P/ASX 200 ex Property Accumulation Index Monthly. Further information on changes to the Fund's benchmark is available upon request.

‡ Excess return: The difference between the portfolio's return and the benchmark return.

Market review

Australian equities generated their best monthly return in two and a half years during February as companies delivered results slightly better than feared.

The S&P/ASX 200 Accumulation Index returned 6.0% for the month, taking its return for 2019 to 10.1%. In aggregate February reporting season was largely in line with subdued expectations, though upward revisions from Resources offset downgrades elsewhere. The market's strong return came from earnings multiple expansion, with the S&P/ASX 200's 12-month forward P/E rising from 14.9 to 15.6 times. Globally, equities rose in response to more dovish outlooks from central banks as global growth slows.

At a sector level, only Consumer Staples (-1.5%) declined in value. Supermarket groups Woolworths (WOW, -0.9%) and Coles (COL, -9.4%) weighed on the index as their 1H19 results revealed higher cost pressures and increased capex required in stores, systems and distribution centres. Elsewhere, Blackmores (BKL, -27.7%) also delivered a poor 1H19 result.

Conversely, the Banking sector (+8.5%) outperformed following the release of the Financial Services Royal Commission Final Report. The recommendations were not as severe as expected, while Commonwealth Bank's (CBA, +8.8%) 1H19 result and quarterly updates from the other major banks were generally in line with expectations.

Elsewhere, Energy (+7.9%) rallied in response to higher oil prices, with Brent Crude rising 9.0% to $US66 per barrel in the month. Top performers included WorleyParsons (WOR, +8.3%), Woodside Petroleum (WPL, 9.4%) and Santos (STO, +8.3%).

Metals & Mining (+6.4%) also contributed to the index's return, largely due to iron ore producers BHP Billiton (BHP, +6.9%), Rio Tinto (RIO, +10.5%) and Fortescue Metals Group (FMG, +12.6%) which continued to rise due to expected supply disruptions from Vale's Brazil operations following a deadly mining disaster in late January.

Portfolio review

Key contributors

James Hardie (JHX, overweight) – the building materials company outperformed following a better-than-expected 3Q19 result. While net profit was largely in line with expectations at $US65.9mn, the full-year guidance range was tightened to $US295-310mn, higher at the midpoint than the previous range of $US280-320mn. Furthermore, the new chief executive announced an ambitious $US100mn cost-out target over the next three years. 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 the company does annually). Lastly, JHX now trades at a more supportive 16.1 times forward earnings, an attractive discount to the ASX Industrials sector.

CSL (CSL, underweight) – the biotechnology company underperformed following a mixed 1H19 result. While management upgraded FY19 guidance – NPAT is now expected to be at the top end of the $US1,880-1,950mn range – the company's strong sales outlook was marred by emerging vulnerability in sales for the Albumin division and higher-than-expected operating expenditure (which has negative implications for the EBIT margin outlook). We remain underweight CSL based on its forward valuation (30.2 times P/E and 21.0 times EV/EBITDA on a 12-month forward basis), which we believe appropriately captures the current earnings outlook.

ANZ Bank (ANZ, overweight) – the bank re-rated following the release of the Financial Services Royal Commission Final Report, which made recommendations that were not as severe as expected. Further, updates from ANZ and the other major banks were generally in line with expectations despite a challenging environment. ANZ's 1Q19 update showed solid capital levels, with a CET1 ratio of 11.3% above its peers. In our view the Royal Commission's Final Report clears the uncertainty pervading the industry and should alleviate pressure, enabling ANZ to generate above system credit growth through its mortgage market share and via an ongoing rebound in small-to-medium enterprise lending.

Key detractors

TPG Telecom (TPM, overweight) – the telco underperformed during the month, following comments from competitor Telstra (TLS) in its 1H19 result that margins for its Fixed business will reduce to zero unless NBN wholesale prices are changed, causing concerns about TPM's margins. We remain overweight the stock based on our positive view of the company's proposed merger with Vodafone. We expect the combined entity will unlock significant synergies and harness its infrastructure, scale and balance sheet to disrupt incumbents TLS and Optus through a lower-cost structure. As a result, we anticipate market share gains will accelerate across the Mobile, Fixed and Corporate divisions. While the ACCC's concerns about the proposed merger have caused uncertainty, we believe the issues are addressable and that, while delayed, the deal will not be blocked.

NEXTDC (NXT, overweight) – the data centre operator underperformed following its 1H19 result. Management downgraded FY19 revenue guidance from $183-188mn to $180-184mn, however this was entirely due to its acquisition of Asia Pacific Data Centre (APDC), which removed distribution income from APDC and lowered interest income from a lower cash balance. Otherwise the result was in line with expectations, with EBITDA guidance reiterated at $83-87mn. We continue to believe 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.

Carsales.com (CAR, overweight) – the online automotive classifieds company underperformed following a worse-than-expected 1H19 result. NPAT missed consensus forecasts by 7% as the domestic core business slowed to flat growth and finance earnings declined materially, offsetting a strong result from the International division. Management guided to moderate revenue, EBITDA and NPAT growth for the 2H19, causing consensus to downgrade FY19 NPAT forecasts by 4-6%. We believe the earnings miss is largely cyclical and remain overweight the stock. We continue to see CAR's valuation – at a forward P/E of 22.1 times – as supportive when considering the company's outlook for long term earnings growth, its conservative accounting (with low capitalisation of research and development investment) and its undervalued international businesses.

Key purchases

Incitec Pivot (IPL) – we established a position in the explosives and fertiliser producer during the month. We believe IPL trades at an attractive valuation when considering its long-term outlook. While disruptions to operations from severe weather will impact earnings in FY19, lead indicators suggest demand is improving for its key commodities, urea and diammonium phosphate. Further, its explosives business is experiencing more stable pricing as mining demand normalises. At 15.3 times forward earnings, IPL trades well below the wider Industrial sector and at an historically wide discount to key competitor Orica (ORI), which trades at 17.7 times.

JB Hi-Fi (JBH) – we re-established a small overweight position in the electronics retailer following its 1H19 result. We believe FY19 earnings guidance is conservative when considering the resilience of JBH's sales in difficult trading conditions, which is not currently reflected in its valuation (at 10.5 times forward earnings). More broadly, we continue to believe concerns regarding Amazon's entry into the Australian market are overplayed with respect to the electronics retailer. 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. While The Good Guys subsidiary has a more conservative outlook amid heightened price competition and a slowing housing environment, we believe the business is better equipped to deal with these issues, with improved supplier support since moving into the JBH group and upside from improved execution.

BHP Billiton (BHP) – we continued to reduce our underweight position during the month following the Vale dam failure in Brazil. While the Vale failure has only a small impact on the global seaborne market (less than 1% of supply), it creates uncertainty about Vale's other Brazilian operations and puts into question around 5% of global supply. However, we remain

underweight the company as new supply comes onto the market from elsewhere and China's demand wanes from strong, stimulus-induced levels. We continue to monitor BHP's ability to support earnings through lower costs – cost inflation is building and we believe capex will need to increase to more historic levels.

Key sales

Super Retail Group (SUL) – we reduced our position in the retailer following its FY19 result. While the result was stronger than expected and speaks to a positive outlook in the short term, we believe this is outweighed by longer-term headwinds from constrained earnings growth (particularly in Leisure) and management team changes. We continue to prefer Kathmandu (KMD) and Bapcor (BAP), which provide more concentrated exposures to outdoor adventure and automotive parts retailing.

Iluka Resources (ILU) – we reduced our holdings in the mineral sands producer during the month, but still retain a small overweight position. We continue to believe ILU's valuation (at a 12-month forward P/E of 9.9 times) is attractive when considering the outlook for robust earnings from its high-quality assets and dominant position in the zircon and titanium dioxide feedstock markets. However, we believe mineral sands prices are close to peak levels, which is at odds with optimistic consensus forecasts for further price increases.

Atlas Arteria (ALX) – we trimmed our holdings during the month following a period of strong outperformance. However, the stock remains the highest conviction overweight in the portfolio: 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 French toll road assets.

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. We believe the approval by securityholders to internalise management in May 2018 is a significant step towards ultimately simplifying the ownership structures of the company'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 consequently is well placed to continue to return capital to shareholders, particularly following the sale of its life insurance business. In our view the Financial Services Royal Commission's Final Report clears the uncertainty pervading the industry and should alleviate pressure, enabling ANZ to capitalise on its ability to generate above system credit growth through its mortgage market share. Further, we expect the company will benefit from an ongoing rebound in small-to-medium enterprise lending. We view the company's discount to peers as attractive at a P/E multiple of 11.8 times and a price to book multiple of 1.3 times.

Origin Energy (ORG) – we are overweight the company on the grounds that its recent initiatives to simplify the business will unlock 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

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 10.7 times forward earnings and 1.3 times book value – as being appealing when considering these headwinds.

CSL (CSL) – we remain underweight CSL based on its forward valuation (30.2 times P/E and 21.0 times EV/EBITDA on a 12-month forward basis), which we believe appropriately captures the current earnings outlook at this time. 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. Notwithstanding recent supply disruptions, we believe fundamentals point to lower prices as new supply comes onto the market and China's demand wanes from strong, stimulus-induced levels. We continue to monitor BHP's ability to support earnings through lower costs – cost inflation is building and capex will need to increase to more historic levels.

Market outlook

We believe fundamentals including employment and population growth point to a robust Australian economy, tempered by moderating growth, falling house prices and soft consumer confidence. Nevertheless, the outlook for company earnings appears solid, supported by select Resources and 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 4.7% on a 12-month forward basis (before franking) versus 2.1% from the Australian 10-year government bond yield.

Global macroeconomic risks persist, though, and require careful monitoring. We remain alert to economic and geopolitical risks, including rising interest rates in the US, slowing global economic growth, 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, Consumer Staples and Health Care.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	8.72	3.56	5.17
Consumer Discretionary	5.62	6.28	-0.66
Consumer Staples	0.00	5.31	-5.31
Energy	10.83	5.87	4.96
Financials	31.58	32.33	-0.74
Health Care	5.23	8.42	-3.19
Industrials	17.60	8.00	9.60
Information Technology	1.63	2.27	-0.64
Materials	17.33	18.65	-1.32
Real Estate	0.00	7.30	-7.30
Utilities	0.00	2.02	-2.02

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Commonwealth Bank of Australia	10.19	7.94	2.25
Westpac Banking	8.96	5.65	3.31
ANZ Banking	8.38	4.94	3.44
Atlas Arteria	4.86	0.29	4.57
Transurban	4.18	1.98	2.20

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	4.86	0.29	4.57
ANZ Banking	8.38	4.94	3.44
Origin Energy	4.12	0.79	3.33
Underweights			
National Australia Bank	0.00	4.18	-4.18
CSL	1.39	5.35	-3.96
BHP Billiton	3.87	6.68	-2.81

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	-2.40	6.05	-0.70	2.51
Distribution return	4.85	4.33	6.28	7.63

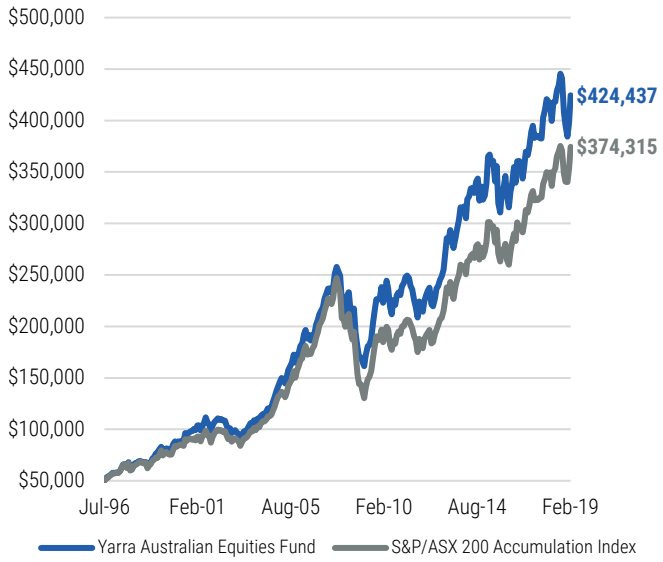
The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders 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 companies listed on the Australian Securities Exchange. In doing so, the aim is to outperform the S&P/ASX 200 Accumulation Index over rolling 3-year periods.	
Recommended investment time frame	5 - 7 + years	
Fund inception	July 1996	
Fund size	Pooled Fund A$582.17 mn as at 28 February 2019	
APIR codes	JBW0009AU	
Estimated management cost	0.95% p.a.	
Buy/sell spread	+/- 0.15%	
Platform availability	AMP PortfolioCare AMP Wealthview AMP Flexible Lifetime ANZ Grow Wrap Asgard BT Wrap BT Panorama Colonial FirstWrap Hub24 IOOF Pursuit Select Macquarie Wrap Accumulator	Macquarie Wrap Consolidator Netwealth North Oasis OnePath PortfolioOne PowerWrap SimpleWrap SmartWrap Wealthtrac

Investment performance comparison of $50,000

After fees, since inception of the Yarra Australian Equities Fund, July 1996 to February 2019.



For illustrative purposes only. Past performance does not guarantee future results, which may vary. The total net fund returns shown are prepared on an exit to exit basis (i.e. they include all ongoing fees and expenses and assume reinvestment of all distributions). They do not take personal taxation into account. The comparison with the S&P/ASX 200 Accumulation Index is for comparative purposes only. Index returns do not allow for transactional, management, operational or tax costs. An index is not managed and investors cannot invest directly in an index.

Applications and contacts

Investment into the Yarra Australian Equities Fund can be made by Australian and New Zealand resident investors only.

Website www.yarracm.com

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