YARRA
CAPITAL MANAGEMENT

Investment Commentary
Quarter to 31 December 2019

Yarra Australian Equities Fund

Gross returns as at 31 December 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	-0.78	1.10	24.47	9.66	8.72	8.13	11.08
S&P/ASX 200 Accumulation Index†	-2.17	0.68	23.40	10.26	8.97	7.86	9.55
Excess return (before fees)‡	1.38	0.42	1.07	-0.60	-0.25	0.27	1.53

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 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	-0.86	0.86	23.30	8.63	7.70	7.11	10.07
S&P/ASX 200 Accumulation Index†	-2.17	0.68	23.40	10.26	8.97	7.86	9.55
Excess return (after fees)‡	1.30	0.18	-0.10	-1.63	-1.27	-0.75	0.52

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 rose modestly in the December quarter as strong returns from Health Care were offset by weakness across Banking and Consumer Staples.

The S&P/ASX 200 Accumulation Index increased by 0.7% in the quarter. Local shares significantly underperformed overseas indices, with the MSCI World Index and S&P 500 returning 7.6% and 9.1% respectively on the back of increased optimism around a China-US trade deal. For the full year, the S&P/ASX 200 Index returned 23.4%, lagging the S&P 500's 31.5% return.

Health Care's (+14.0%) strong return for the quarter was in large part due to CSL (CSL, +18.0%), which continued to benefit from its strong position in the global plasma industry where demand is exceeding supply. Other top performers included Fisher & Paykel (FPH, +32.3%), ResMed (RMD, +10.7%) and Cochlear (COH, +8.0%).

Elsewhere, gains were widespread across Resources. In Metals & Mining (+4.1%) the resilient iron ore price supported BHP Group (BHP, +6.0%), Rio Tinto (RIO, +8.3%) and Fortescue Metals Group (FMG, +21.5%). Energy (+6.4%) benefited from higher oil prices and Caltex (CTX, +29.0%), which proposed an IPO of its property assets and received an $8.6bn takeover offer from Canadian convenience store operator Alimentation Couche-Tard that was subsequently rejected.

Conversely, the banking sector (-9.4%) declined in response to FY19 results and, moreover, allegations from AUSTRAC that Westpac (WBC, -15.8%) breached anti-money laundering (AML) regulations, resulting in the resignation of the chief executive and early retirement of the chairman.

In Consumer Staples (-2.7%), Woolworths (WOW, -3.0%) and Coles (COL, -3.6%) retraced outperformance from the prior quarter as valuation concerns outweighed better-than-expected 1Q20 sales growth. Treasury Wine Estate (TWE, -12.5%) fell after announcing its chief executive would depart in the second half of 2020.

For CY19, Health Care (+43.5%) generated the strongest return, followed by Information Technology (+33.5%) and Consumer Discretionary (+32.4%). In contrast, Banking (+9.4%), Utilities (+16.2%) and Consumer Staples (+21.0%) were the largest underperformers.

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Portfolio review

Key contributors

National Australia Bank (NAB, underweight) – the bank underperformed following the release of a soft 2H19 result. Net profit after tax (NPAT) was 1-2% below expectations, driven by a greater net interest margin (NIM) decline than expected and subdued loan growth. We do not hold a position in NAB with our preferred bank exposure being 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. Furthermore, the new chief executive, who commenced in December, may seek to reset market expectations. We do not regard NAB's valuation – at 11.9 times forward earnings and 1.3 times book value – as being appealing considering these headwinds.

James Hardie (JHX, overweight) – the building materials company outperformed after delivering a strong 2Q20 result and in response to improving US housing construction data. NPAT of US$98.6mn was ahead of market expectations, driven by higher North American (NA) margins and solid volumes across the Asia-Pacific. Moreover, management upgraded full-year guidance to adjusted NPAT of US$325-365mn and NA margin guidance to 25-27%. We remain overweight, as we expect input costs will continue to moderate from elevated levels, generating higher margins in FY20, and remain confident in JHX's market share outlook over the medium to long-term as primary demand growth accelerates following resolution of US supply and manufacturing issues. JHX trades at 21.7 times forward earnings, an attractive discount to the ASX Industrials ex-Financials sector (23.1 times) given its strong growth outlook.

Worley (WOR, overweight) – the engineering services company outperformed during the quarter amid higher oil prices, with Brent Crude rising +8.3% to US$S66 per barrel. We remain overweight WOR because we believe the company's exposure to oil and gas (primarily through its hydrocarbons business) will see gains from increased capital expenditure across the industry. As activity levels increase, strong operating leverage – driven by management's focus on high staff utilisation and cost control – should drive earnings above consensus expectations. We also hold a positive view of the company's acquisition of Jacobs ECR in April 2019, which provides material revenue and cost synergy opportunities. Lastly, WOR trades at 15.0 times forward earnings, which we view as attractive given its strong growth potential.

Bluescope Steel (BSL, overweight) – the steel producer outperformed during the quarter in response to a well-received investor day and encouraging macro lead indicators, both for global economic growth and Australian housing. We continue to see upside from BSL's strong position to benefit from a pick-up in building approvals (3-6 month lag for steel demand). More broadly, we are positive on the stock due to BSL's high-quality assets (domestically and internationally), its strong balance sheet, capital management initiatives and supportive valuation (15.1 times forward earnings). 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, which we believe is underappreciated by the market. In the long-term, we expect BSL will remain soundly profitable and cash-flow positive, even when the cycle troughs.

Origin Energy (ORG, overweight) – the energy company outperformed during the quarter in response to higher oil prices (with Brent Crude up 8.3% to US$66 per barrel) and a warm reception to its 2019 investor day. Management reiterated guidance in the Energy Markets business for underlying EBITDA of $1.4-1.5bn, with the >$100mn cost out target on track, and modestly increased APLNG's production guidance to 690-710PJs. We remain overweight ORG because we see upside to cash flows and dividends versus consensus forecasts. With a payout ratio of 50%, the company offers an attractive forecast dividend yield of 4.3% on a 12-month forward basis. While ORG's Energy Markets business will likely experience slowing earnings growth in FY20, we believe this is largely factored into market expectations. Lastly, 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 next step in crystallising this value.

Key detractors

CSL (CSL, underweight) – the biotechnology company outperformed during the quarter after reiterating FY20 earnings guidance at its AGM and as industry participants noted demand was exceeding supply in the immunoglobulin market, suggesting higher prices for CSL's IG products. We remain underweight CSL based on its forward valuation (37.8 times P/E and 26.1 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.

Westpac Bank (WBC, overweight) – the bank underperformed after AUSTRAC launched civil proceedings against the bank for alleged anti-money laundering (AML) breaches, resulting in the resignation of the chief executive and early retirement of the chairman. Additionally, WBC released its 2H19 result during the quarter: while the $2.5bn capital raising and 15% dividend cut were in line with expectations, management's FY20 outlook disappointed the market, with management forecasting flat loan balances and 1% expense growth. Following the company's response to the AUSTRAC matters, we believe appropriate accountability has now been demonstrated. Our overweight position in WBC remains predicated on easing housing market headwinds, a benign bad debt environment, significant productivity opportunities and an attractive valuation (at 13.0 times forward earnings).

ANZ Bank (ANZ, overweight) – the bank underperformed during the quarter in response to its weaker-than-expected 2H19 result. Pre-provision profits fell 1.6% (h/h) to $5.16bn, 2-3% below consensus forecasts. The main driver was ANZ's net interest margin (NIM), which declined 6 bps (h/h) largely as a

result of lower rates. The outlook commentary was also disappointing, with management lowering their internal view of cost of capital from 10% to 8.5% on expectations that the trend for declining returns will continue. Our overweight position in ANZ remains predicated on easing housing market headwinds, a benign bad debt environment, significant productivity opportunities and an attractive valuation (at 11.8 times forward earnings).

Vocus Group (VOC, overweight) – the telco underperformed during the quarter without any company-specific news. However, the market may have become more cautious towards the stock following Telstra's (TLS) investor day, where management called out challenges in its Enterprise division following NBN's entry into the top end of the market. Nevertheless, we remain overweight the company. We continue to see further upside from the combination of new management, improving fundamentals and quality of the asset base. Following two unsuccessful takeover approaches, 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 that will come from successfully implementing these improvements.

Fortescue Metals Group (FMG, underweight) – the iron ore producer outperformed in response to resilient iron ore prices, with the commodity remaining above US$90 per tonne during the quarter. Additionally, the company delivered a solid 1Q20 report, with costs below the guidance range, a smaller realised discount for its 58% Fe product and net debt shrinking to $0.5bn. We remain underweight FMG based on our long-term view that additional iron ore supply will come into the market, more than offsetting the recent deficit caused by the Vale supply disruption, and that China's demand will wane from strong, stimulus-induced levels.

Key purchases

Aristocrat Leisure (ALL) – we established a position in the gaming company during the quarter. In our view ALL is a compelling growth stock, with a dominant position in land based games (65% of EBIT) and significant opportunities from Digital (35% of EBIT), which has a wide range of outcomes. ALL trades at 20.6 times forward earnings, moderately below its Industrial peers but with superior organic growth prospects and a strong balance sheet.

Unibail-Rodamco-Westfield (URW) – we initiated a position in URW during the quarter following an extended period of underperformance. While we acknowledge known challenges to the retail shopping mall outlook globally, we see an opportunity specifically in URW. Firstly, the REIT owns larger, well located malls with high barriers to entry, attractive food and entertainment draw cards, and infrastructure access advantages. Secondly, URW provides investors solid geographical asset exposures. Around 65% of its malls (by value) reside in the better performing Continental European region, where we expect to see positive rental growth over 2019. Lastly, URW offers valuation support, trading at a material 35% discount to NAV and with a 7.5% dividend yield. While gearing is higher than peers (38% at June 2019) it is important to note URW remains substantially within its debt covenants (60% LTV) with an ongoing asset disposal program in place to reduce debt levels.

BHP Billiton (BHP) – we increased our holding in the company during the quarter, moving from an underweight to modestly overweight position. We view BHP as a relatively defensive Metals & Mining exposure, with a diversified portfolio, strong balance sheet and clear strategy of capital allocation. While we continue to believe that iron ore fundamentals remain negative in the long term, we expect Chinese demand will remain supportive in the short term.

Key sales

Sydney Airport (SYD) – we reduced our position in the airport owner during the quarter following recent outperformance. However, we remain overweight SYD. In our view the company is set to benefit from a supportive demand backdrop – the airport captures approximately 40% of Australia's inbound air passengers – and has strong barriers to entry as Sydney's only international airport. SYD's higher prices and robust passenger numbers support strong revenue growth which, when combined with its high operating leverage, enable the company to grow its dividend by mid-single digits on a five-year compound annual growth rate.

Commonwealth Bank (CBA) – we reduced our position size as the company's valuation (at 16.4 times forward earnings) trades well above peers, but retain a smaller position. While the recent FY19 result was disappointing – with revenue trends soft (expected) and costs growing (unexpected) – we continue to see upside as CBA takes advantage of stable banking fundamentals. We expect the bank to deliver stable net interest margins, low to mid-single digit credit growth and cost reductions going forward. Further, housing market headwinds appear to be easing, with the sector benefitting from APRA's recent decision to ease mortgage serviceability requirements. That being said, our preferred banking overweight exposures are ANZ Bank (ANZ) and Westpac Bank (WBC), which trade at 11.8 times and 13.0 times forward earnings respectively.

NEXTDC (NXT) – we reduced our position size in the data centre operator during the quarter to reflect higher capacity risk as large customers increasingly build their own data centres. That being said, we continue to believe the business is structurally set to benefit from increasing adoption of cloud technology and is accelerating its expansion to meet client demands. To this end, NXT is currently building three new data centres which will support significant medium to longer term earnings growth.

Key active overweights

Atlas Arteria (ALX) – we maintain a high-conviction overweight position in ALX based on the continued strong operational performance of its attractive, long-dated assets and discounted valuation of 11 times EV/EBITDA, which is in part due to its historically complicated ownership structure. ALX has now undergone an extensive transformation: the internalisation of management in April 2019 and, secondly, through a deal made in November 2019. The agreement

removes Macquarie Group (MQG) as a manager of its key asset, unlocks cash flow, gives ALX greater control over the French toll road and puts ALX in play as a takeover target. As a result, we now believe there is now a clear line of sight towards realising the intrinsic value of its assets, resulting in significant upside.

Origin Energy (ORG) – we are overweight ORG because we see upside to cash flows and dividends versus consensus forecasts. With a payout ratio of 50%, the company offers an attractive forecast dividend yield of 4.3% on a 12-month forward basis. While ORG's Energy Markets business will likely experience slowing earnings growth in FY20, we believe this is largely factored into market expectations. Lastly, 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.

James Hardie (JHX) – our overweight position is premised on the building materials company continuing to take market share and increase margins in its key North American business (70% of value), input costs moderating from elevated levels and an attractive valuation. We are confident in the company's market share outlook due to its high-quality and reliable products, improved sales strategies (that position the product as superior versus alternatives) and primary demand growth accelerating following resolution of US supply and manufacturing issues. JHX trades at 21.7 times forward earnings, a meaningful discount to the ASX Industrials ex-Financials sector (23.1 times).

Westpac Bank (WBC) – our overweight position remains predicated on easing housing market headwinds, a benign bad debt environment, significant productivity opportunities and an attractive valuation (at 13.0 times forward earnings). Following the company's response to the AUSTRAC allegations of alleged anti-money laundering (AML) breaches – including the resignation and forthcoming departure of the chief executive and chairman respectively – we believe appropriate accountability has now been demonstrated.

Star Entertainment (SGR) – our overweight position is premised on the belief that the market underestimates SGR's ability to enhance asset performance through operational improvements and capex programs. In our view, the company's brownfield developments – the expansion in Sydney, the redevelopment on the Gold Coast and the Queen's Wharf in Brisbane – provide meaningful upside opportunities in the next few years. As a result, we find SGR's valuation appealing at a 12-month forward P/E of 17.1 times, representing a significant discount to peer Crown Resorts (CWN) at 21.9 times.

Key active underweights

CSL (CSL) – we remain underweight CSL based on its forward valuation (37.8 times P/E and 26.1 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. While the higher margin Specialty Product division (18% group sales in FY19) has provided strong margin growth for the group in recent years, we view its growth outlook as being more challenged given the repositioning of competitor products. Lastly, while Seqirus (12% group sales in FY19) offers a diversified exposure within CSL's portfolio, we do not believe the business warrants the same premium multiple as the plasma business, supporting our decision to remain underweight at this time.

National Australia Bank (NAB) – we do not hold a position in NAB, with our preferred banking exposures being 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. Furthermore, the new chief executive, who commenced in December, may seek to reset market expectations. We do not regard NAB's valuation – at 12.4 times forward earnings and 1.3 times book value – as being appealing considering these headwinds.

Woolworths (WOW) – we remain underweight WOW, reflecting concerns across both the supermarket and discretionary retail businesses and the stock's stretched valuation at 26.6 times forward earnings. 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 discount department store Big W remains challenged, particularly considering the threat of online and the need to rationalise excess store capacity. WOW has announced plans to combine Endeavour Drinks and pubs and pokies company ALH Group and de-merge from the group. The proposal does not alter our view on the stock, given our concerns are focused on the outlook for the core supermarkets and discretionary retail businesses.

Wesfarmers (WES) – our underweight position in the conglomerate is premised on the grounds that its divisions, outside Bunnings (57% of EBIT), face significant earnings headwinds. Officeworks (6% of EBIT) and the department store industry (including discount department stores Target and Kmart, 19% of EBIT) face increasing competition (e.g. Amazon) and excess physical store capacity. Furthermore, WES's Industrials segment (18% of EBIT) comprises cyclical, lower quality businesses. As such, we don't find the valuation attractive at 23.5 times forward earnings, above the wider Industrial ex-Financials' 23.1 times.

Macquarie Group (MQG) – we are underweight the investment bank on the grounds that while MQG is a high-quality business, the recent step up in earnings is unsustainable, having been driven by its lower quality (highly cyclical) businesses. We remain underweight the stock given consensus has only partially factored in lower FY20 guidance, and MQG's valuation remains unattractive (at a 12-month forward P/E of 15.8 times).

Market outlook

We believe fundamentals including employment and population growth point to a stable Australian economy, tempered by soft business and consumer confidence. Tentative signs of stabilisation have emerged and 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 4.1% on a 12-month forward basis (before franking) versus 1.4% 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 an escalation in the US-China trade war, slowing global economic growth and the potential re-emergence of quantitative easing.

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, and underweight Health Care, Consumer Staples and Financials.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	7.38	3.56	3.81
Consumer Discretionary	8.40	6.68	1.72
Consumer Staples	0.00	5.70	-5.70
Energy	10.10	5.44	4.66
Financials	24.77	29.82	-5.05
Health Care	4.26	10.44	-6.18
Industrials	15.15	8.44	6.71
Information Technology	0.97	2.52	-1.55
Materials	17.99	18.14	-0.15
Real Estate	6.52	7.41	-0.90
Utilities	2.91	1.85	1.06

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Commonwealth Bank of Australia	8.17	7.86	0.31
Westpac Banking	7.57	4.65	2.92
BHP	6.82	6.40	0.42
ANZ Banking	6.48	3.98	2.50
Atlas Arteria	5.04	0.37	4.67

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Atlas Arteria	5.04	0.37	4.67
Origin Energy	4.50	0.83	3.67
James Hardie Industries	4.17	0.69	3.48
Underweights			
CSL	1.74	6.97	-5.24
National Australia Bank	0.00	3.97	-3.97
Woolworths	0.00	2.65	-2.65

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	3.45	-0.48	-0.02	-1.65
Distribution return	19.85	9.10	7.71	8.76

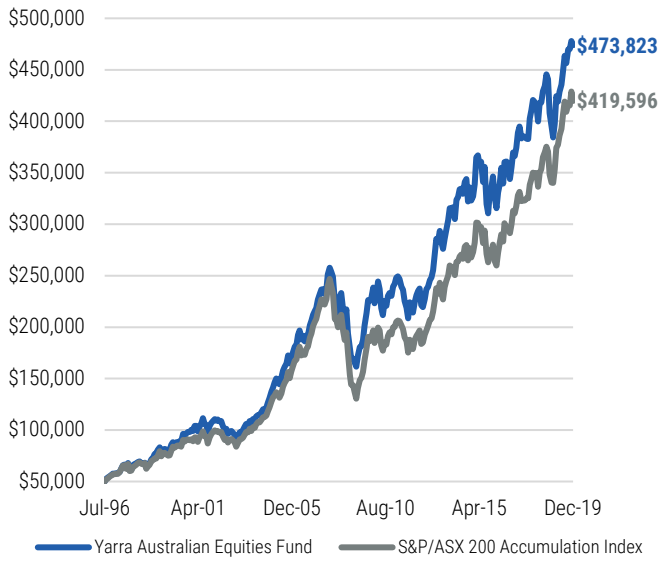
The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders 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$146.10 mn as at 31 December 2019	
APIR codes	JBW0009AU	
Estimated management cost	0.90% p.a.	
Buy/sell spread	+/- 0.15%	
Platform availability	AMP Flexible Lifetime AMP PortfolioCare AMP Wealthview ANZ Grow Wrap Asgard BT Panorama BT Wrap Colonial FirstWrap Freedom of Choice Hub24 IOOF Pursuit Select	Macquarie Wrap Accumulator Macquarie Wrap Consolidator Netwealth North Oasis OnePath PortfolioOne PowerWrap SmartWrap Wealthtrac

Investment performance comparison of $50,000

After fees, since inception of the Yarra Australian Equities Fund, July 1996 to December 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

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

Disclaimers

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

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