YARRA CAPITAL MANAGEMENT

Investment Commentary
Quarter to 30 September 2023

Yarra Emerging Leaders Fund (Direct)

Gross returns as at 30 September 2023

	1 month^ %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception^ % p.a.
Yarra Emerging Leaders Fund (Direct)	-4.50	-3.22	15.75	9.22	6.42	10.20	12.77
Emerging Leaders Combined Benchmark†	-4.32	-1.81	8.56	6.63	4.59	8.15	7.92
Excess return (before fees)‡	-0.18	-1.41	7.19	2.59	1.83	2.05	4.84

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 September 2023

	1 month^ %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception^ % p.a.
Yarra Emerging Leaders Fund (Direct)	-4.65	-3.68	13.59	7.16	4.28	7.87	10.47
Emerging Leaders Combined Benchmark†	-4.32	-1.81	8.56	6.63	4.59	8.15	7.92
Excess return (after fees)‡	-0.33	-1.87	5.03	0.53	-0.31	-0.28	2.54

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.

^ Note: Due to a Melbourne public holiday, Fund performance in September 2023 was calculated up to 28 September 2023, whereas Benchmark performance is shown to 29 September 2023. Fund performance for 29 September 2023 will be captured in October 2023 month-end performance. Further information relating to Unit Pricing calculations can be found in the Fund PDS.
^ Inception date Yarra Emerging Leaders Fund (Direct): November 1994
† Comprising 50% S&P/ASX Midcap 50 Accumulation Index and 50% S&P/ASX Small Ordinaries Accumulation Index
‡ Excess return: The difference between the Fund's return and the benchmark return.

Market review

The Emerging Leaders Benchmark declined a modest 1.8% for the quarter, taking its 12-month return to +8.6%. By comparison, the broader ASX 300 returned -0.8% for the quarter and, globally, the MSCI World Index fell by 3.4% for the period.

Energy (+21.6%) rallied during the quarter, with all sub-sectors delivering strong positive returns. Paladin Energy (PLD, +50.7%) and Ampol (ALD, +16.0%) largely explained this strong performance. Paladin Energy benefitted from the uranium price increase of ~20% for the quarter (despite not yet being in production) and Ampol from the continuing rise of the Brent oil price.

Within Communication Services (+9.4%), Carsales.com (CAR, +18.6%) was a significant driver of the sector's return. The online car classifieds company demonstrated strong yield growth potential across all its operating segments. Another notable stock contributor for the period was REA Group (REA, +8.4%).

Conversely, the weakest performing sector was Materials (-9.3%) with the Diversified Metals and Mining sub-sector contributing most negatively to returns. Allkem (AKE, -26.6%) was one of the main detractors reflecting weakness observed across the lithium industry and increased capex guidance. Other notable laggards were Chalice Mining (CHN, -62.9%) and Iluka Resources (ILU, -30.6%).

Portfolio review

Key Contributors

Megaport (MP1, overweight) – our overweight position in the software technology company outperformed following a positive FY23 results and FY24 guidance. FY23 EBITDA increased materially to $20m compared to the prior period loss of $10m with revenue growth remaining strong at +40% yoy. FY24 EBITDA guidance has been upgraded multiples times over recent months with the cumulative uplift in EBITDA expectations over +50%. The solid earnings result was due to stronger than expected pricing and cost reductions. We continue to hold the position as we believe customer volume trends will improve in the medium to long term as execution improves. Furthermore, we would highlight that yield growth, low customer churn, margin expansion (including cost reduction programs) and lower capex will support a transition

to free cashflow positive in CY24 with significant cashflow potential longer term.

Carsales.com (CAR, overweight) -- the online auto classifieds company outperformed during the period following its full-year result. The result proved up CAR's investment case of the recent acquisitions of Trader Interactive in the US business and Webmotors in Brazil, with both businesses demonstrating double digit yield growth as dynamic pricing models were introduced. Combined with a strengthened market position in Australian private car sales, there is now much greater visibility around continued price and yield increases across the business.

Worley (WOR, overweight) – the leading provider of global engineering services outperformed during the period as the share price reached its highest level since 2020. We attribute this outperformance to increasing market awareness of the margin expansion opportunity that the company detailed at its recent investor day. We continue to like WOR as we expect margins will accelerate over the coming years as the company benefits from a more consolidated industry structure, operating leverage, and active mix management.

Allkem (AKE, underweight) – our underweight in the lithium producer was a source of outperformance during the period following broad weakness in the lithium industry coupled with increased capex guidance at the company's Olaroz, Sal de Vida, Cauchari, James Bay and Mt Cattlin operation plants. We see risks to consensus lithium price assumptions this year given continued spot market declines as EV sales growth moderates in China in response to more challenging economic conditions.

WiseTech Global (WTC, underweight) – the logistics industry software solutions provider underperformed during the period following its full-year result, which included earnings guidance for the next financial year that fell well short of consensus estimates. The miss was driven by higher-than-anticipated investment expenses and margin dilution from recent acquisitions.

Key Detractors

Iluka Resources (ILU, overweight) – our overweight position in the mineral sands company was a detractor during the quarter. Iluka reported a 10% decline in mineral sands revenue and a 22% decline in underlying EBITDA in its FY23 results, with the market concerned over the short-term outlook for mineral sands demand notwithstanding ILU's commentary of flat pricing in the second half. We continue to like mineral sands markets long-term and favour ILU 's leverage as the world's largest Zircon producer and fifth largest producer of titanium feedstocks. Iluka is moving into Rare Earths production through the Eneabba refinery and should be a critical component producer for the EV industry.

Healius (HLS, overweight) – the pathology and medical imaging company underperformed post the competition regulator (ACCC) raising concerns over its merger with Australian Clinical Labs (ACL). While recent HLS operational performance has been significantly impaired by a combination of below normal pathology volumes (slow rebound in business-as-usual activity following COVID) and elevated operational costs (elevated COVID-testing related costs), we see an opportunity under the new CEO to improve business focus, enhance operational margins and rebuild balance sheet resilience.

Kelsian (KLS, overweight) – the transport services operator detracted during the period despite delivering a solid operating result for FY23. We have a positive view across the three divisions of Australian buses, US buses and Australian tourism. We believe the Australian bus business will return to earnings growth given the defensive nature of existing contacts with cost pass through, extra charter work, new government contracts in Sydney and improved staff availability. The US bus business has a strong demand outlook from new and existing customers and with pricing increases to offset cost inflation. The Australian tourism assets will benefit from the post COVID-19 recovery across both international and domestic visitors with several years of pent-up demand.

Alumina (AWC, overweight) – our overweight position in the alumina producer was a detractor during the period following its half-year results. We are concerned that environmental approvals to mine near to the Serpentine dam may not be received in a timely manner, and the company has less than 12 months of remaining low-grade ore to mine at Huntly. We see a material risk that the Kwinana and Wagerup refineries may be forced to curtail production or even close at a time where the company's debt levels are approaching unsustainable levels. This has led us to exit the stock position.

Sims (SGM, overweight) – the steel manufacturer underperformed during the period following a lack of improvement in trading conditions. Due to ongoing weakness in the US domestic market supply, the 1Q14 EBIT was expected to breakeven. We believe Sims is trading below mid-cycle earnings and represents attractive value at these levels. A skew towards improving environmental performance on increased capital spend in this area should position the business strongly relative to peers as environmental regulations tighten.

Key Purchases

Centuria Capital (CNI) – we took the opportunity to initiate a position in the diversified fund manager following the release of the companies FY23 result and our positive assessment of the group's ability to navigate through the current weakness in commercial real estate markets. In our view, the company's result demonstrated they proactive approach to managing debt levels across the business. We believe CNI's strategy has sufficient flexibility to maintain a degree of momentum by tilting towards more in-favour property sub-sectors (i.e., healthcare, agriculture). Finally, CNI's valuation already captures expected cyclical headwinds across commercial property from the rising interest rate environment, with the stock trading on undemanding multiple of 11.2 times FY24 P/E and offering a 7.6% dividend yield.

Vicinity Centre (VCX) – we increased our position in the shopping mall owning REIT in the period. Key supportive factors include VCX's retail asset mix, with over half its asset base exposed to more advantaged segments of bricks & mortar retailing (i.e., luxury, DFO outlets and recovering CBDs), more resilient in-place leases with high occupancy and fewer holdovers. Additionally, VCX has a strong balance sheet (gearing 25.7% as at Dec-22) and attractive valuation, with the stock trading at 0.80-times net asset backing and offering a dividend yield above 6%.

Carsales.com (CAR) – we took the opportunity to increase our position in the online car classifieds company, which has demonstrated strong yield growth potential across all of its operating segments. In Australia, which represents approximately 50% of CAR's valuation, CAR is seeing improving yields from products such as Instant Offer and Select along with a strengthen competitive position in private sales. CAR's recent acquisition of the US business Trader Interactive and Brazilian business Webmotors have both demonstrated strong yield growth as new dynamic pricing models are introduced. The visibility on CAR's medium term revenue growth has improved which makes the 31.2 times FY24 earnings multiple the stock trades on relatively undemanding given the tailwinds.

Key Sales

Alumina (AWC) – we exited our position in the alumina producer following the company's 1H23 result. We are concerned that environmental approvals to mine near to the Serpentine dam may not be received in a timely manner, and the company has less than 12 months of remaining low-grade ore to mine at Huntly. We see a material risk that the Kwinana and Wagerup refineries may be forced to curtail production or even close at a time where the company's debt levels are approaching unsustainable levels.

Seek (SEK) – we exited our position in SEK during the quarter. We believe the company has the potential to sustain growth given its strong position, with the company currently holding 31% share in the Australian market. However, as we are approaching 12 months post SEK's inclusion in the ASX 50 Index we are required to exit the position.

Iluka (ILU) – we trimmed a small portion of our position in the mineral sands producing company during the period on expectations of soft demand in the second half of 2023. We share the market's concerns over the short-term outlook for mineral sands demand, notwithstanding ILU's commentary of flat pricing in the second half. However, we remain attracted to the mineral sands market in the long-term and favour ILU 's leverage as the world's largest Zircon producer and fifth largest producer of titanium feedstocks. Iluka is moving into Rare Earths production through the Eneabba refinery and will, in our view, be a critical component producer for the EV industry.

Key Active Overweights

Reliance Worldwide (RWC) – we view the plumbing supplies company as a compelling opportunity, with the market capitalization a softer FY24 earnings year (P/E of only 14.0 times vs 17.0 times mid cycle) which we believe doesn't give appropriate credit to the mid-cycle earnings power of the group considering the resilience of its end markets, the majority of which relates to more non-discretionary, repair type housing activity.

Carsales.com (CAR) – we are overweight the online car classifieds company which has demonstrated strong yield growth potential across all its operating segments. In Australia, which represents approximately 50% of CAR's valuation, CAR is seeing improving yields from products including Instant Offer and SELECT, along with a strengthened competitive position in private sales. CAR's acquisitions of US business Trader Interactive and Brazilian business Webmotors have both demonstrated strong yield growth as new dynamic pricing models are introduced. The visibility on CAR's medium term revenue growth has improved which makes the 31.5 times FY24 earnings multiple the stock trades on relatively undemanding given the tailwinds.

Worley (WOR) – we remain overweight the leading provider of global engineering services. WOR's earnings recovery is in its early stages following the COVID-19 impacts across FY20-22. Revenue is expected to grow 13-15% in FY24, with leading indicators (Factored Sales Pipeline +36%, Rolling 12 Month Bookings +28%, Backlog +8%) and structural drivers (capital investment required to decarbonise) pointing to strong top-line growth ahead. Margins are also set to increase over the coming years as WOR benefits from a more consolidated industry structure, operating leverage, and active mix management.

NEXTDC (NXT) – the portfolio maintains an overweight position in the leading Australian data centre owner and developer. The company has a unique combination of a strong long term earnings growth profile, combined with infrastructure like characteristics and solid returns on capital backed by a tangible asset base. NXT currently trades on 29.3 times FY25 EV/EBITDA, which compares favourably to its more mature global peers.

Netwealth Group (NWL) – we maintain an overweight position in the leading independent wealth management platform. NWL is set to continue strong revenue growth for the foreseeable future, capturing an outsized level of funds under administration as Australia's wealth management industry fragments away from the historically dominant players. In our view, the company's 26.8 times EV/EBITDA multiple does not capture its long-term growth opportunity, high incremental margins, conservative accounting, and strong cash flow generation.

Key Active Underweights

WiseTech Global (WTC) – we remain underweight the leading developer of software solutions for the logistics industry, with a preference for other names in the technology sector given WTC's demanding valuation of 76.7-times 1-year forward P/E. We believe WTC has (and is continuing to build) an exceptional product in CargoWise, which should continue to attract and retain large freight forwarders.

Ampol (ALD) – we retain an underweight position in ALD, given structural challenges from declining retail fuel/tobacco volumes and dilutive returns from the EV transition expected to persist over the longer-term. While ALD has continued to execute against its Convenience strategy, the nature of the format remains uncertain and cyclical refining margins remain elevated. With the company trading on a FY24 earnings multiple of 12.1-times and a 6% dividend yield, we believe better opportunities can be found elsewhere at this time.

Washington H Soul Pattinson (SOL) – we do not hold a position in the diversified investment company. At this time, we see better direct investment opportunities available than those offered through SOL's broad suite of investments across the telco, mining, manufacturing, health care and funds management sectors. We also remain cautious on the company's exposure to coal via its 37.8% stake in coal miner New Hope (NHC).

REA Group (REA) – we hold an underweight position in Australia's largest online residential real estate platform business, and instead gain indirect preferred exposure to the online real estate segment via Domain Holdings (DHG) through the portfolio's position in Nine Entertainment (NEC) (which owns 60% of DHG). REA trades on a multiple of 44.6-times FY24 P/E, and we currently see superior risk adjusted returns in other high-growth online businesses such as Carsales.com (CAR).

Orica (ORI) – we remain underweight the Australian-based mining and infrastructure solutions company. From a chemicals exposure perspective, our stock preference is Incitec Pivot (IPL). Notwithstanding a number of improvements in the visibility of earnings growth for ORI (repricing low margin contracts, premiumization strategy in detonators), we believe the stock factors in these benefits with the company trading on a forward P/E of in excess of 16-times.

Market outlook

With the major central banks declaring that further interest rates are now data dependent and as evidence continues to accumulate that inflation continues to moderate, our long-held view that mid-2023 would mark the top of the interest rate cycle appears to be broadly on track. Crucially, both labour markets and core services inflation have eased in recent months and forward indicators suggest further progress should be made through the rest of 2023.

Moreover, the pessimistic tone of the economic activity data in the US that threatened a technical recession has given way to slightly more upbeat data in recent weeks encouraging the belief that the US will escape a technical recession in 2023. Indeed, some leading indicators are suggesting that a broader turn in the global industrial cycle is at hand, which should encourage a rotation from a narrow mega-cap tech led equity market rally to broader participation in 2023.

Indeed, our leading indicators suggest the negative earnings per share revisions trend has now largely run its course which when combined with a levelling out in economic momentum and an end to the interest rate tightening cycle will likely provide greater confidence in underlying valuations and a shift from bearish equity positioning. Bond yields continue to provide the more significant challenge to equity market valuations, albeit the lift in bond yields into mid-2023 can mostly be attributed to a significant lift in the supply of US bonds as the US budget deficit continues to increase sharply, thereby providing a counter cyclical boost to economic growth.

Economic growth has also slowed in Australia, recording just 0.4%q/q growth in the June quarter, repeating the same languid growth recorded in the March quarter. Indeed, with population growth running at a 2.5% annualised pace in the six-months to June and economic growth expanding at an annualised 1.8% pace over the same period, Australia has recorded its first per capita recession since mid-2006 (excluding the COVID lockdown period). It is clear the prior tightening of monetary policy is having a material impact on the interest rate sensitive parts of the economy. For instance, discretionary consumption volumes have declined 0.6% (six-month annualised) as non-discretionary household expenses and interest costs soared by 16%yoy – the fastest annual increase since 1989. Building approvals continue to decline – now down 45% from the 2021 peak - and are likely to fall further in coming months as declining housing affordability outweighs the impact of an under supplied housing market.

Nevertheless, the good news is that after a pause in the tightening cycle in July, The Reserve Bank of Australia (RBA) has remained on hold and flagged that future monetary policy adjustments will be data dependent. To be clear, the RBA retains a tightening bias, however an update of their inflation forecasts now has inflation returning to inside the target band in 2025, providing a signal that absent any unexpected inflation shocks the RBA's rate tightening cycle is complete. The RBA also revised down economic growth modestly to just 1.0% in 2023, acknowledging that local economic growth had faltered. It is of note the that the RBA's forecasts for domestic growth are now below our own for the first time since 2019.

Australia should still be able to avoid a technical recession due to four key reasons:

1. Australia has been a net beneficiary of global commodity shortages and the prior surge in commodity prices. Although commodity prices remain elevated from a historical perspective, they are now off their peaks., The impact of moving through the peak will be for nominal GDP growth to slow quickly over the next six months, removing some of the cushion that has protected corporate profits, tax receipts and wage growth.
2. The household sector continues to hold a significant buffer of excess savings which can be used to smooth consumption growth amid acute cost of living pressures. Nevertheless, our analysis suggests that the residual of the savings buffer skews to older households, leaving younger and more indebted

households exposed. As such, we remain particularly cautious on discretionary retail spending.

3. Australia remains incredibly well placed to benefit from the global energy transition. Lithium is already a A$10bn export industry domestically and Australia is the world's dominant producer. Electric Vehicle sales are forecast to increase 10 times by 2030 and Australia has the world's second largest copper resource. LNG is an important energy transition fuel – it currently accounts for 23% of global electricity generation – and Australia just happens to be the world's equal largest exporter of LNG. The limiting factor nearer term is that escalating costs and project delays risk pushing out the economic benefits.
4. Net migration into Australia contracted in 2021 for the first time since 1945. However, a very strong recovery was recorded through 2022 and a record level of net migration has occurred in recent months, ensuring that Australia's population growth will exceed 2.5% in 2023. This will be the primary mechanism keeping Australia out of recession, yet it comes with the complication of exacerbating the rental shortage evident across all capital cities.

While the RBA has been later than most other developed nations, we believe financial conditions are now firmly in the restrictive zone. While interest rate hikes in Australia will remain a month-to-month proposition, our analysis suggests that the RBA should have concluded its hiking cycle. Moreover, we do expect that the RBA will commence a modest easing cycle in 1H24, most likely commencing in May 2024.

The A$/US$ had been under downward pressure as markets grappled with a seemingly more hawkish Fed relative to the RBA and poor sentiment on the economic outlook for China. However, with Australia's external accounts remaining in excellent health, our expectation that Australia's economic growth will prove more robust, and the prospect the US$ down trend will re-emerge as the Fed pivots from its hiking strategy to an easing cycle in early 2024, we expect the A$/US$ will appreciate to the low-70s towards mid-2024.

We are most overweight stocks within the Communication Services, Health Care and Information Technology sectors, and are underweight Energy, Materials and Consumer Discretionary.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	13.11	6.60	6.52
Consumer Discretionary	8.43	11.45	-3.02
Consumer Staples	1.15	3.02	-1.87
Energy	0.00	6.64	-6.64
Financials	12.53	12.49	0.03
Health Care	7.25	4.80	2.45
Industrials	14.91	13.53	1.38
Information Technology	10.55	8.79	1.76
Materials	16.87	22.15	-5.28
Real Estate	9.68	9.27	0.41
Utilities	0.00	1.25	-1.25

Top 5 holdings

	Portfolio %	Benchmark %	Active %
Carsales.com	6.22	2.03	4.19
Worley	4.97	1.23	3.74
Reliance Worldwide	4.88	0.59	4.29
NEXTDC	4.87	1.23	3.64
Netwealth Group	3.65	0.38	3.27

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Reliance Worldwide	4.88	0.59	4.29
Carsales.com	6.22	2.03	4.19
Worley	4.97	1.23	3.74
Underweights			
WiseTech Global	0.00	2.29	-2.29
Ampol	0.00	1.55	-1.55
Washington H. Soul Pattinson and Co.	0.00	1.54	-1.54

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	12.25	6.12	3.44	6.91
Distribution return	1.35	1.03	0.84	0.97

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 small and medium sized Australian companies that are considered to possess strong capital growth potential. In doing so, the aim is to outperform the benchmark over rolling 3-year periods.
Recommended investment time frame	5 - 7 + years
Fund inception	November 1994
Fund size	A$94.3 mn as 30 September 2023
APIR codes	JBW0007AU
ARSN code	089 909 106
Distribution frequency	Semi-Annually
Estimated management cost	1.90% p.a.
Buy/sell spread	+/- 0.20%

The Yarra Emerging Leaders Fund (Direct) is not available for new investment. Where existing reinvestment instructions are in place, distributions may be reinvested.

Applications and contacts

The Yarra Emerging Leaders Fund (Direct) is no longer available for new investment. The reinvestment of distributions is still allowed where an existing reinvestment instruction is in place.

Website www.yarracm.com

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

Disclaimers

The Yarra Emerging Leaders Fund (Direct) is substantially invested in the Yarra Emerging Leaders 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. The Fund's benchmark comprises 50% S&P/ASX Midcap 50 Accumulation Index and 50% S&P/ASX Small Ordinaries Accumulation Index.

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