

# Yarra Leaders Fund

## Gross returns as at 30 September 2023

	1 month <sup>^</sup> %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Leaders Fund <sup>^</sup>	-2.86	-1.90	18.42	14.41	6.58	7.51	9.29
S&P/ASX 100 Accumulation Index	-2.75	-0.71	13.66	11.89	7.27	7.67	9.37
Excess return (before fees) <sup>‡</sup>	-0.11	-1.18	4.77	2.52	-0.68	-0.17	-0.09

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 <sup>^</sup> %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception* % p.a.
Yarra Leaders Fund <sup>^</sup>	-2.98	-2.25	16.73	12.75	4.90	5.70	8.98
S&P/ASX 100 Accumulation Index	-2.75	-0.71	13.66	11.89	7.27	7.67	9.37
Excess return (after fees) <sup>‡</sup>	-0.22	-1.54	3.07	0.86	-2.37	-1.97	-0.39

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.

<sup>^</sup> 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 Leaders Fund: October 1998

<sup>^</sup> This Fund is no longer available for new investment. The Reinvestment of distributions is still allowed where an existing Reinvestment instruction is in place.

<sup>‡</sup> Excess return: The difference between the Fund's return and the benchmark return (S&P/ASX 100 Accumulation Index).

### Market review

Australian equities weakened during the September quarter, with the Energy sector being the top contributor and the Health Care sector delivering the weakest performance.

The S&P/ASX 100 Accumulation Index returned -0.7% for the quarter, taking its 12-month return to +13.7%. On a similar note, the broader S&P/ASX 300 reported a return of -0.8% for the period. Globally, the MSCI World Index fell by 3.4%.

Energy (+9.5%) was the top performing sector during the quarter with Woodside Energy (WDS, +9.5%) the key contributor. WDS outperformed as the oil and gas producer benefitted from the continuing rise of the Brent oil price, with Santos (STO, +6.9%) also a beneficiary.

Consumer Discretionary (+6.2%) was another strong sector performer during the period, with Wesfarmers (WES, +9.2%) a significant driver after the diversified conglomerate reported solid financial results, led by Kmart (+8.8% sales in 2H23) and Bunnings (+0.8% sales in 2H23).

Conversely, the weakest performing sector was Health Care (-9.1%). CSL (CSL, -8.9%) was the largest negative contributor, as the globally focused biotechnology company continued to weaken following the August reporting season which

confirmed the recent (June) downgraded FY24 earnings guidance, continued industry news flow on a potential blood plasma substitute product and investor uncertainty heading into the investor day.

### Portfolio review

#### Key Contributors

**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.

**CSL (CSL, underweight)** – our underweight to the globally focused biotechnology company contributed positively to performance during the quarter, as the stock continued to weaken following the pre-release in June of FY24 group earnings guidance which was below market expectations (around 10% lower than consensus for group FY24 NPATA). The weaker operating outlook was driven by lower growth in

**NO LONGER AVAILABLE FOR NEW INVESTMENT**

the core blood plasma business, Behring, as cost pressures pushed out the margin recovery story. We retain our cautious outlook for Behring, driven by increased competition, elevated and prolonged cost pressures, adverse relative product growth rates and longer-term product substitution risk. Trading on 25.9-times forward FY24 P/E, we currently retain an underweight position.

**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.

### Key Detractors

**Resmed (RMD, overweight)** – our overweight position in the medical equipment manufacturer detracted during the month following the release of its full-year results. We would characterise the share price weakness as driven by firstly an increased focus on the potential future impact of weight loss drugs GLP-1s on the sleep-apnoea market and, secondly, an eventual return of competitor Phillips into the sleep-apnoea device market in the USA. There was also a degree of gross margin disappointment following delivery of the company's full year result. Notwithstanding the above factors, we continue to see a solid market penetration outlook for RMD's CPAP devices, and hence believe these are factored into expectations at current levels with the stock trading on an attractive valuation (21.7 times P/E FY24 vs 28.1 times long-term average).

**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.

**National Australia Bank (NAB, underweight)** – the banking sector performed well during the period as the market began to place a higher probability on an economic soft landing and interest rates remaining higher for longer. We remain underweight the sector, with the banks facing material earnings pressures through declining net interest margins, elevated expense growth and a normalisation in bad debt expenses, all of which suggest sector EPS is likely to be at peak levels.

### Key Purchases

**APA Group (APA)** – we initiated a position in the gas transmission pipeline company via participation in an equity raising used to fund the Alinta's Pilbara assets. The acquisition of the Alinta assets gives APA an attractive platform to deploy capital into the decarbonisation of mining operations in the Pilbara through the development of renewable generation and transmission infrastructure. APA trades on a valuation of 11.3 times FY24 EV/EBITDA and a 6.5% dividend yield, which we view as an attractive entry point.

**Stockland (SGP)** – we initiated a position in Australia's largest residential land developer based on a view of the company's capacity to benefit following a peaking of interest rates, quality land assets in key growth corridors across Australia and well-funded financial position. Stock valuation is supportive, with the stock offering a 6% dividend yield and trading below net asset backing.

**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%.

**ResMed (RMD)** – we added to our RMD position to take advantage of a recent share price weakness following the release of the FY23 results. The stock has sold off due to concerns around a range of factors including gross margins, the competitive landscape and the impact of emerging weight loss drugs which may impact the addressable market for sleep-apnoea device sales. We are not as bearish on these issues, with our favourable view predicated on RMD's large and underpenetrated market (sleep and COPD (chronic obstructive pulmonary disease)), clear operating leverage over time and its strong track record of capital deployment as the business shifts further into digital, connected care solutions for its patient base. We took the opportunity to add to the position, with the stock trading at an attractive valuation (21.7 times P/E NTM vs 28.1 times long-term average).

### 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.

**Woodside Energy (WDS)** – we took the opportunity to trim the position size of oil and gas producer WDS following a period of outperformance during the month. The company is benefitting

from rising oil prices, with the Brent marker increasing 19% during the quarter. We are attracted to the company's strong growth profile from new projects that remain on budget and schedule to increase production by more than 30% over the next two years.

**Telstra (TLS)** – we took the opportunity to reduce our position in the telecommunications company, reflecting a more cautious view on the mobile market and an increased reliance on the segment for earnings growth. Mobile pricing accounted for the vast majority of group EBITDA growth in 2H23, as post-paid subscriber additions slowed, and churn increased. This dynamic may prove more challenging moving forward as inflation eases and CPI-linked increases moderate, while the outlook for mobile competition remains a risk given Optus has yet to move post-paid pricing.

### **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.

**ResMed (RMD)** – we remain overweight the medical device company with a positive view of the potential growth opportunity. The stock sold off during the quarter due to concerns around a range of factors including gross margins, the competitive landscape and the impact of emerging weight loss drugs which may impact the addressable market for sleep-apnoea device sales. We are not as bearish on these issues, with our favourable view predicated on RMD's large and underpenetrated market (sleep and COPD (chronic obstructive pulmonary disease)), clear operating leverage over time (SG&A and R&D) and a strong track record of capital deployment as the business shifts further into digital, connected care solutions for its patient base.

**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.

### **Key Active Underweights**

**National Australia Bank (NAB)** – we remain underweight the Australian bank reflecting our negative sector view. In our view, Australia's banks are facing material earnings pressures through declining net interest margins, elevated expense growth and a normalisation in bad debt expenses, meaning sector EPS is likely to be at peak levels.

**CSL (CSL)** – we retain an underweight to the globally focused biotechnology company. Underpinning this position is our view that earnings growth from its core blood plasma division (approximately 65% of group earnings) will be more difficult moving forward due to elevated and sticky cost pressures, increased competition, relative product growth rates away from higher margin specialty products and longer-term product substitution risk. While the more recently acquired business, Vifor (now approximately 15% of group earnings) does provide differentiation, we view the business as lower quality than the core plasma franchise. Considering this operating FY24 outlook, we do not regard the current valuation (26.7 times FY24 P/E, 18.4 times EV/EBITDA) as overly attractive at this time.

**Macquarie Group (MQG)** – we remain underweight the stock based on the view the recent earnings uplift is driven by its lower quality and highly cyclical businesses, which we view as unsustainable into the medium term. We see significant downside risk to consensus forecasts beyond FY24, which currently reflects a strong contribution from lumpy items including trading revenue in its commodities business, gains on sale, performance fees and low loan-loss provisions. We do not expect growth in the more stable businesses to be able to offset this. As a result, we regard MQG's headline forecast P/E multiple of 15.1 times consensus forward earnings as unattractive.

### **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 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, Utilities and Information Technology sectors, and are underweight Financials, Consumer Staples and Health Care.

## Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	11.06	3.84	7.22
Consumer Discretionary	5.06	5.80	-0.74
Consumer Staples	0.00	4.64	-4.64
Energy	5.88	5.67	0.21
Financials	22.33	30.43	-8.10
Health Care	5.57	9.20	-3.63
Industrials	10.45	6.91	3.55
Information Technology	5.96	2.29	3.67
Materials	21.37	24.28	-2.91
Real Estate	5.02	5.26	-0.23
Utilities	5.69	1.67	4.02

## Top 5 holdings

	Portfolio %	Benchmark %	Active %
BHP Group	12.63	11.67	0.96
Commonwealth Bank of Australia	6.90	8.73	-1.83
Woodside Energy	5.88	3.61	2.28
Westpac Banking	5.35	3.86	1.49
QBE Insurance	4.35	1.22	3.13

## Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Reliance Worldwide	3.59	0.16	3.43
ResMed	3.89	0.48	3.41
Worley	3.53	0.33	3.20
Underweights			
National Australia Bank	0.00	4.75	-4.75
CSL	1.68	6.30	-4.62
Macquarie Group	0.00	3.14	-3.14

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	4.15	1.08	-6.31	-5.07
Distribution return	12.58	11.67	11.21	10.77

The Growth Return is measured by the movement in the Fund's unit price, ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders by way of income distribution in a 12-month period. It does not include capital distributions.

## Features

Investment objective	To achieve medium to long-term capital growth by investing in larger companies listed on the Australian Securities Exchange, and in doing so outperform the S&P/ASX 100 Accumulation Index over rolling 3-year periods.
Recommended investment time frame	5 - 7 + years
Fund inception	October 1988
Fund size	A\$44.1 mn as at 30 September 2023
APIR code	JBW0011AU
ARSN code	090 047 662
Estimated management cost	1.45% p.a.
Buy/sell spread	+/- 0.15%

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## Applications and contacts

The Yarra Leaders 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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