YARRA CAPITAL MANAGEMENT

Investment Commentary
Month to 31 October 2023

Yarra Australian Equities Fund

Gross returns as at 31 October 2023

	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	-4.06	-9.61	5.61	11.10	6.82	6.54	10.13
S&P/ASX 200 Accumulation Index†	-3.78	-7.19	2.95	8.88	7.17	6.59	8.79
Excess return (before fees)‡	-0.28	-2.42	2.66	2.22	-0.36	-0.06	1.34

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 October 2023

	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	-4.13	-9.81	4.67	10.11	5.85	5.55	9.13
S&P/ASX 200 Accumulation Index†	-3.78	-7.19	2.95	8.88	7.17	6.59	8.79
Excess return (after fees)‡	-0.36	-2.62	1.72	1.23	-1.32	-1.04	0.34

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

The Australian Equities market retraced in October, recording the largest monthly drawdown during the past 12 months. The S&P/ASX 200 Accumulation Index returned -3.8% for the month, taking its 12-month return to +3.0%. Similarly, the broader ASX 300 Accumulation Index declined by 3.8%. Globally, the MSCI World Index declined 2.9%.

Utilities (+1.7%) was the only positive performing sector during the month, with Origin Energy (ORG, +4.0%) being the largest contributor. The integrated energy producer and retailer rose during the month following the ACCC granting authorization for its proposed acquisition by Brookfield/EIG to proceed. Given at least one major shareholder has declared that they would not support the deal at the proposed price, ORG's share price rose in anticipation of an improved bid.

Conversely, Information Technology (-7.6%) was among the weakest performers, with the Software & Services sub-sector largely responsible for the sector's return. Both WiseTech Global (WTC, -10.6%) and Xero (XRO, -5.1%) continued their downward trend from the prior month despite no material news.

Health Care (-7.2%) was another challenged sector during the month, with CSL (CSL, -7.4%) being the key driver of underperformance. The biotechnology company's share price worsened following concerns that GLP-1 drugs could threaten the level of demand for some of its product, including kidney disease fighting drugs supplied from its Vifor franchise. Other laggards include Cochlear (COH, -5.7%) and ResMed (RMD, -7.7%).

Portfolio review

Key Contributors

Northern Star Resources (NST, overweight) – the gold producer performed strongly in October, with gold prices increasing by 7.1% during the month to close at US$1,996/oz. NST released a solid production report for the September quarter and retained full year cost and production guidance, with expectations for a stronger 2H24 from grade improvements at its KCGM and Jundee mines, ramp up of the Thunderbox mill and improved production at Pogo.

Origin Energy (ORG, overweight) – the integrated energy producer and retailer rose during the month following the ACCC support for the proposed acquisition by Brookfield/EIG. Given two large shareholders have declared they would not support the deal at the proposed price, ORG's share price rose in anticipation of an improved bid.

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CSL (CSL, underweight) – the globally focused biotechnology company underperformed during the month, reflecting increasing concerns relating to the potential impact of GLP-1 weight-loss drugs on the sales trajectory for some of CSL's products. Overall, share price weakness can be attributed to uncertainty around the operating outlook for the core plasma franchise relative to strong prior years driven by competitive dynamics and cost pressures. These drivers manifest in creating a degree of uncertainty around the speed of the margin recovery story for Behring.

Key Detractors

Tyro (TYR, overweight) – the payments terminal provider underperformed following its investor day during the month which delivered little in the way of strategic change and highlighted shifting dynamics within the payments sector. TYR had raised expectations leading into the investor day around a potential shift in how it offers banking products, however there was no change forthcoming which disappointed the market. TYR also noted that it had observed that a small number of its point-of-sale software partners have shifted their revenue models to include payments, which points to an increase in competitive intensity in its core verticals.

Tabcorp (TAH, overweight) – the wagering operator underperformed following the release of its quarterly update. TAH reported a -6.1% decline in 1Q24 revenue as the wagering market softened, reflecting a moderation in activity post-COVID and broader consumer weakness. TAH also saw a degree of yield contraction which exacerbated this trend, as generosities increased and unfavourable results/mix saw revenues decline ahead of turnover (-1%). We continue to see opportunity in the stock over the medium term, and view TAH as a net beneficiary of the upcoming Victorian wagering license tender and regulatory alignment between retail and digital operators.

Reliance Worldwide (RWC, overweight) – the plumbing supplies company underperformed as ongoing softer underlying activity market for RWC in 2023 makes the short-term earnings trajectory less certain. Nonetheless, RWC provided a solid 1Q24 trading update as part of its 2023 AGM during the month, reiterating FY24 margin outlook. However, the update did highlight softness in a segment of RWC's European market with commercial niche product FluidTech performing below expectations (low double-digit sales decline). With relatively low market expectations, an improving balance sheet, cash flow generation and controllable continual improvement opportunities, we continue to see value in the stock, which trades on an attractive 13.7-times P/E.

Key Purchases

Pilbara Minerals (PLS) – we have shifted our lithium exposure from IGO to PLS. PLS is a pure-play lithium producer, and with lithium prices approaching trough levels we are seeking to increase our leverage to the commodity. Additionally, we see lower capex and new project timeline risk within PLS relative to IGO.

Vicinity (VCX) – we increased our position in the shopping mall owning REIT. 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 25.6% as at June-2023) and an attractive valuation, with the stock trading at 0.75-times net asset backing and offering a dividend yield in excess of 6.5%.

Region (RGN) – we increased our position in the shopping mall owning REIT after the stock fell 6.5% in September. We view RGN's retail asset base as the most defensive in nature, given its high proportion of rents from supermarket tenancies and non-discretionary specialty tenants. We believe the stock price captures excess level of direct asset valuation declines at current levels (0.83-times last book value).

Key Sales

Stockland (SGP) – we exited our position in SGP over the month reflecting the superior risk-return outlook offered by the portfolio's other REIT positions. Relative share price moves encouraged us to concentrate our REIT investments into VCX and RGN and exit SGP.

IGO (IGO) – we have shifted our lithium exposure from IGO to PLS. PLS is a pure-play lithium producer, and with lithium prices approaching trough levels we are seeking to increase our leverage to the commodity. Additionally, we see lower capex and new project timeline risk within PLS relative to IGO.

Chorus (CNU) – whilst we retain a favourable view on the outlook for CNU, we chose to rotate the position into infrastructure names Transurban (TCL) and APA Group (APA) where we have a higher level of conviction.

TPG Telecom (TPG) – we divested from the Australian telco following the announcement of the potential $6.3bn sale of its Vision/EG&W assets. While we see evidence of improved operating momentum, the proposed sale also concentrates TPG's exposure in mobiles, with medium term earnings growth contingent on repricing and ongoing mobile rationality. This may prove more challenging as inflation eases and CPI-linked increases moderate, while the outlook for mobile competition remains a risk given Optus has yet to move its postpaid pricing.

Key Active Overweights

ResMed (RMD) – we remain overweight the medical equipment company which we view as the most attractive large-cap healthcare company on the ASX today. The stock has sold off due to concerns around a range of factors including the impact on its installed base of CPAP devices following the emergence of weight loss drugs (GLP-1s), recent gross margin slippage versus expectations and competitive landscape changes (Philips remains out of the market on hardware in the USA). 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 its strong track record of capital deployment as the business shifts further into digital, connected care solutions.

CAR Group (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 its valuation, CAR is seeing improving yields from products such as Instant Offer and Select in Australia, along with a strengthened competitive position in private sales. CAR's recent 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, meaning the 29.0 times FY25 earnings trading multiple relatively undemanding given these tailwinds.

QBE Insurance (QBE) – the global general insurer remains our preferred insurance exposure, which will continue to deliver strong earnings growth in 2024 and beyond supported by sustained premium rate growth and the beneficial impact of higher interest rates on investment earnings. QBE has substantially improved its underwriting discipline and product focus over the last five years, and we believe it's 8.9-times FY24 earnings multiple excessively discounts the risks inherent in its business model.

Key Active Underweights

National Australia Bank (NAB) – we remain underweight the Australian bank reflecting our negative sector 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 decline in FY24 and FY25.

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 challenged 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 its more recently acquired business Vifor (now approximately 15% of group earnings) does provide differentiation, we view the business as lower quality than CSL's core plasma franchise. Considering this operating FY24 outlook, we do not regard the current valuation (26.6-times P/E, 18.0- times EV/EBITDA) as overly attractive at this time.

Macquarie Group (MQG) – we remain underweight the stock based on the view that the strong earnings delivered in FY22 and FY23 were driven by its lower quality and highly cyclical businesses, which we view as unsustainable into the medium term. This was evident in MQG's 1H24 result which saw earnings decline 38% on the prior comparative period to a level we regard as more reflective of the underlying earnings power. On this level of earnings, the business trades on a 22.0 times earnings multiple. Consensus has factored in a sharp rebound in cyclical earnings streams in 2H24 and beyond, however we would prefer to revisit on a lower multiple.

Market outlook

Major central banks have become more strident in declaring that interest rates are now likely at the peak. In the case of the UK, the Bank of England (BoE) has effectively endorsed the markets expectations for interest rate declines in 2024. Moreover, in the US, the Federal Open Market Committee (FOMC) have yet to walk back their guidance of material rate reductions in 2024 and 2025. The primary force behind this shift is the ongoing accumulation of evidence that inflation continues to moderate, inclusive of easing stresses in the labour market and in core services inflation. Forward indicators suggest further progress should be made through the rest of 2023 and early 2024.

Moreover, the pessimistic tone of the economic activity data in the US that threatened a technical recession has given way to more updated data in recent months 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 and 1H24.

The negative EPS revisions trend has now run its course. Annual growth in EPS is moving positive which, when combined with better-than-expected economic momentum and an end to the interest rate tightening cycle, provides 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% growth (q/q) 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% (y/y) – the fastest annual increase since 1989. Building approvals continue to decline – now down 43% from the 2021 peak – and are likely to fall further in coming months as declining housing affordability outweighs the impact of an undersupplied housing market.

Post the September quarter CPI print, the Reserve Bank of Australia (RBA) was left with little option but to hike interest rates by 25bps. Both the quarterly print and the composition of the inflation print was sufficient to lift the RBA's forecast path

for inflation at a time when the RBA had already declared minimal tolerance for a slower normalisation in inflation. To be clear, the RBA retains a tightening bias. However, their updated guidance is 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. Commodity prices are now off their peaks, and although they remain very elevated from a historical perspective, the impact of moving through the peak will be that nominal GDP growth will 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 which is 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 2H24, most likely commencing in August 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, Information Technology and Utilities sectors, and are underweight Financials, Consumer Staples and Health Care.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	9.59	4.02	5.56
Consumer Discretionary	7.16	6.90	0.25
Consumer Staples	0.00	4.52	-4.52
Energy	5.65	5.79	-0.15
Financials	20.12	28.75	-8.64
Health Care	4.70	8.72	-4.02
Industrials	9.31	6.72	2.59
Information Technology	5.86	2.34	3.51
Materials	22.74	24.80	-2.06
Real Estate	6.82	5.80	1.02
Utilities	5.09	1.62	3.47

Top 5 holdings

	Portfolio %	Benchmark %	Active %
BHP Group	11.45	11.21	0.24
Commonwealth Bank of Australia	6.00	8.05	-2.05
Woodside Energy	5.65	3.23	2.41
Westpac Banking	4.70	3.59	1.11
QBE Insurance	3.89	1.16	2.74

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
ResMed	3.34	0.42	2.92
CAR Group	3.31	0.52	2.79
QBE Insurance	3.89	1.16	2.74
Underweights			
National Australia Bank	0.00	4.38	-4.38
CSL	1.35	5.57	-4.22
Macquarie Group	0.00	2.88	-2.88

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	-0.85	-1.81	-6.99	-3.97
Distribution return	5.52	11.92	12.85	9.53

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	A$103.6 mn as at 31 October 2023
APIR codes	JBW0009AU
Estimated management cost	0.90% p.a.
Buy/sell spread	+/- 0.15%
Platform availability	Asgard Ausmaq BT Panorama BT Super Wrap FirstWrap GrowWrap Hub24 IOOF Pursuit Macquarie Wrap Netwealth Oasis Powerwrap

Investment performance comparison of $50,000

After fees, since inception of the Yarra Australian Equities Fund, July 1996 to October 2023.

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. Note that the minimum initial investment amount for the Yarra Australian Equities Fund is $10,000.

Applications and contacts

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

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