Investment Commentary
Quarter to 31 March 2024

Yarra Emerging Leaders Fund (Direct)

Gross returns as at 31 March 2024

	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)	3.92	7.33	15.24	8.66	10.60	10.49	13.04
Emerging Leaders Combined Benchmark†	4.11	7.11	14.40	5.86	8.21	9.13	8.27
Excess return (before fees)‡	-0.19	0.22	0.84	2.80	2.39	1.35	4.77

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 March 2024

	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)	3.76	6.83	13.09	6.63	8.41	8.17	10.74
Emerging Leaders Combined Benchmark†	4.11	7.11	14.40	5.86	8.21	9.13	8.27
Excess return (after fees)‡	-0.36	-0.28	-1.32	0.77	0.20	-0.96	2.47

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 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 Australian mid and small cap market was positive for the first quarter of 2024.

The Emerging Leaders Benchmark returned +7.1% for the quarter, taking its 12-month return to +14.4%. By comparison, the broader S&P/ASX 300 Accumulation Index gained 5.4% for the period. Globally, the MSCI World Index also recorded a +8.5% return.

Information Technology (+24.7%) was the largest contributor for the quarter, led by WiseTech (WTC, +24.8%). The leading developer of software solutions rallied during the period following the release of strong earnings with robust revenue and EBITDA figures, beating analysts' forecasts. Altium (ALU, +39.9%) was another key contributor, largely driven by the announcement of its acquisition by Japanese chipmaker Renesas Electronics.

The Financials (+11.4%) sector also significantly contributed to performance for the period. Virgin Money UK (VMUK, +34.3%) led the gains following the announcement of its acquisition by Nationwide Building Society in March. Netwealth (NWL, +38.1%) also contributed positively to performance following the release of its 1H24 results which included an 27.2% increase in EBITDA.

In contrast, Materials (-3.2%) was the worst performing sector. Losses were led by Lynas Rare Earths (LYC, -20.5%) following the release of its 1H24 results, where it reported a 74% fall in net profit and a 37% decrease in revenue. IGO (IGO, -20.8%) and Liontown (LTR, -29.1%) also fell during the quarter.

Portfolio review

Key Contributors

Netwealth Group (NWL, overweight) – the leading independent wealth management platform contributed to performance during the period. Outperformance was supported by the release of the 1H24 result where NWL reported a 27.2% increase in EBITDA with margin expansion to 47.6%. NWL is set to continue delivering 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 multiple for FY25 does not capture its long-term growth opportunity, high incremental margins, conservative accounting, and strong cash flow generation.

Reliance Worldwide (RWC, overweight) – the plumbing supplies company outperformed with an encouraging 1H24 result ahead of consensus driven by the core Americas division. We like the scope for recovering activity estimates

(USA, EMEA) as CY24 unfolds. New construction data is starting to see green shoots of improvement, and RWC is executing well rolling out its new product range at better margins. We believe the current stock valuation 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.

NEXTDC (NXT, overweight) – Australia's leading data centre owner reported a solid 1H24 result with contracted capacity of 149MW. Whilst the result was solid, NXT's qualitative outlook commentary was much stronger than expected, pointing to very large deals in their sales pipeline and hyperscale pricing 20-30% above average levels. The company has the unique combination of a structural long term earnings growth profile combined with infrastructure like characteristics, solid returns on capital and is backed by a tangible asset base.

Megaport (MP1, overweight) – our overweight position in the software technology company outperformed following the release of its quarterly result. A strong turnaround in profitability while still investing in growth saw Megaport deliver positive results for the quarter. We continue to hold the position as we believe customer volume trends will progress in the medium to long term as market conditions and 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.

Arcadium (LTM, underweight) – our underweight in the lithium producer was a source of outperformance during the period following continued weakness in lithium prices. The recent merger between Allkem (AKE) and Livent (LTHM.US) to form Arcadium has further increased LTM's exposure to South American lithium brine production and lithium chemicals processing. While we believe lithium prices are approaching trough levels, we continue to see margin compression in lithium processing, and prefer to gain exposure to lithium via Australian hard rock spodumene producers.

Key Detractors

Nanosonics (NAN, overweight) – the infection prevention company underperformed during the period following a disappointing update. NAN continues to experience ongoing uncertainty associated with the impact on the timing of capital unit sales due to hospital capital budgetary pressures. We remain positive on the long-term growth opportunity given the company's position as the global market leader in probe disinfection. We expect strong organic sales growth to be driven by the adoption of the product in existing markets such as the US and Europe and expansion into new markets such as Japan and China.

Sims (SGM, overweight) – the steel recycler underperformed during the period following a weak 1H24 result driven by lower metal trading margins and inflationary pressures. We believe Sims is trading below both mid-cycle earnings and book value. SGM remains a highly cyclical stock that represents attractive value at these levels. A skew towards improving environmental performance on increased capital spend should position the business well relative to peers as environmental regulations tighten.

Evolution (EVN, overweight) – the gold producer underperformed during the period following a poor December quarter production update which fell short of consensus expectations and led to a guidance downgrade at the Red Lake mine. Despite shorter-term production headwinds, we remain attracted to EVN's long-life assets, and meaningful leverage to copper production at the Ernest Henry and Northparkes mines. Continued drilling success across the portfolio, should result in further resource/reserve increases in early 2024.

Nine Entertainment (NEC, overweight) – the media company underperformed during the period following its 1H24 result, guidance signals a deterioration in 3Q from 1H trends driven by metro FTA (Free-to-Air) and radio broadcasting. NEC remains well placed to participate in the eventual cyclical recovery of the advertising market with strong and growing FTA share, a dominant position in BVOD (Broadcast Video on Demand) and a quality set of digital assets including online print and Stan.

Kelsian (KLS, overweight) – the bus and tourism provider underperformed during the period following its 1H24 result. KLS's result highlighted a strong revenue outcome, but was more than offset by elevated D&A expenses. We believe the Australian bus business will return to earnings growth going forward given the defensive nature of existing contacts with cost pass-through, extra charter work and improved staff availability. The US bus business has a strong demand outlook from new and existing customers 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 a number of years of pent-up demand.

Key Purchases

Lifestyle Communities (LIC) – during the month we initiated a small position in one of Australia's leading and highest quality land lease owning and developing business, LIC. While the equity raise and 1H24 earnings update drove EPS downgrades (-15% FY25, -12% FY26) we like the medium-longer term outlook – with the equity raise providing balance sheet support, as well as materially boosting the production capacity at supportive acquisition prices over the coming decade. The equity raise has served to both solve for the nearer term funding tightness and allowed LIC to secure 5 strategic land parcels at a good point in the cycle, de-risking the development delivery timeline out to FY27-FY29.

Liontown (LTR) – we have added to our LTR position. We believe lithium prices have now troughed, and as a result we are seeking to increase our leverage to the commodity. LTR presents as an appealing name to add to in this context, with production and cash flows set to ramp up from its Kathleen Valley project over the next few years. Completion of the recently re-sized debt funding packages also helps derisk the project.

Sims (SGM) – we added to our existing position in the steel recycler during the period. We believe Sims is trading below mid-cycle earnings and asset value and represents attractive value at these levels. A skew towards improving environmental performance on increased capital spend should position the business strongly relative to peers as environmental regulations tighten.

Key Sales

Netwealth Group (NWL) – we resized the position following its strong outperformance. NWL is set to continue delivering 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 multiple for FY25 does not capture its long-term growth opportunity, high incremental margins, conservative accounting, and strong cash flow generation.

Megaport (MP1, overweight) – we trimmed a small portion from our existing position in the software technology company post its outperformance. We continue to hold the position as we believe customer volume trends will progress in the medium to long term as market conditions and 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.

Key Active Overweights

NEXTDC (NXT) – the portfolio maintains an overweight position in leading Australian data centre owner and developer NXT. The company has a unique combination of structural long term earnings growth profile driven by the adoption of cloud and artificial intelligence capabilities, combined with infrastructure like characteristics, solid returns on capital and backed by a tangible asset base.

Reliance Worldwide (RWC) – we view the plumbing supplies company as a compelling opportunity, with cyclical upside as end-markets recover over the period ahead and an improved product mix rolls out. We believe this valuation 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.

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 34.5-times FY25 earnings trading multiple is relatively undemanding given these tailwinds.

Netwealth Group (NWL) – we maintain an overweight position in the leading independent wealth management platform. NWL is set to continue delivering 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 multiple for FY25 does not capture its long-term growth opportunity, high incremental margins, conservative accounting, and strong cash flow generation.

Worley (WOR) – we remain overweight the leading provider of global engineering services. WOR's earnings recovery is in its early stages following 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 towards higher margin sustainability work.

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 116.6-times FY24 forward P/E. We believe WTC have and are continuing to build an exceptional product in CargoWise which should continue to attract and retain large freight forwarders.

REA Group (REA) – we hold an underweight position in Australia's largest online residential real estate platform business, and instead gain indirect exposure to the online real estate segment via Domain Holdings (DHG) through the portfolios position in Nine Entertainment (NEC) (which owns 60% of DHG). REA trades on a multiple of 53.8-times FY24 P/E and we see superior risk adjusted returns in other high-growth online businesses such as Carsales.com (CAR) which trades on 39.2-times FY24 P/E.

Ampol (ALD) – we retain an underweight position in ALD, reflecting our view that F&I and Lytton are overearning vs long-run averages while Future Energy remains a drag. While ALD appear to be navigating the structural issues in Convenience (tobacco, declining fuel volumes), the long-term nature of the format remains uncertain even amid a long-dated energy transition with limited impact to date. With the company trading on a FY25 earnings multiple of 14.4-times and a 5.5% dividend yield we believe better opportunities can be found elsewhere.

Orica (ORI) – We retain an underweight position to the Australian-based mining and infrastructure solutions company ORI. 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 FY25 P/E of in excess of 17.5-times.

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, healthcare, and funds management sectors. We also remain cautious on the company's exposure to thermal coal via its 38% stake in coal miner New Hope (NHC).

Market outlook

The Australian equity market returned a very solid 3.3% in March, completing a 5.3% gain for the March quarter – the strongest March quarter since 2019. In concert with the rally of late 2023 the ASX200 has delivered a six-month annualised return of 14%. Despite the strong performance in large caps, small capitalisation stocks outperformed, returning 4.8% in March and 7.5% for the quarter. The standouts in the month were REITS which have returned 9.2% in March and 16.6% CYTD and gold which returned 9.1% in March and 8.1% CYTD. The laggards in March were alternative assets and the Australian dollar.

Optimism continues to be driven by financial markets becoming increasingly convinced that central banks are now preparing to ease interest rates from mid-2024.

Good news on inflation has also been met with signs of economic resilience. Although Europe continues to toy with a technical recession, the strength of the recovery in Emerging Market industrial production bodes well for a recovery in European demand in 2024, and indeed survey evidence suggests a recovery in European demand has commenced. This strength in Emerging Market growth has largely been in spite of China rather than because of China. Nevertheless, the bout disinflation in China has largely run its course and economic data has become more mixed/positive rather than universally poor. We continue to expect China to deliver on a more meaningful infrastructure package in 2024 and further encourage credit expansion to the real economy which should underpin economic growth around 5% in 2024 – a target that the Chinese government also adopted in recent weeks. As such we expect China to begin to provide a more meaningful support to global economic growth as we move through 2024.

Turning to Australia's prospects despite a weak finish for economic growth in 2023 – expanding just 0.2%qoq and 1.5%yoy - we continue to suggest that not only will Australia avoid a recession it will likely accelerate sequentially through 2024 with the improving global backdrop acting as a tailwind. No one should be disputing that 2023 likely felt like a recession for many Australians. A per capita recession and a negative income shock for those with high debt and young families has cascaded into weak discretionary spending as high interest rates coalesced with surging insurance, utilities, rates, education and food prices. Nevertheless, economic growth was held up by several unusual features this economic cycle vis-à-vis prior cycles;

1. Commodities. Prior commodity price strength continued to underwrite double digit nominal economic growth and profitability.
2. Backlogs. Much has been made of the backlog of work in housing construction that has nullified the typical cyclical shock that is transmitted via the housing construction sector during rate hiking cycles. Approvals and affordability are at very poor levels yet the level of home building has barely declined at all. The backlog in work yet to be done is now peaking at a very high level suggesting we shouldn't be looking at the housing sector as a source of new economic growth, but equally we shouldn't be expecting a precipitous collapse in 2024. That may come in 2025 if interest rates remain at current levels, but that is not our expectation. But less has been made of the backlogs in non-residential building (led by offices, warehouses, health and transport) which equates to 7% of GDP and the backlog of engineering construction (led by roads, railways, electricity and mining which equates to 16% of GDP. This enormous backlog of work has kept upward pressure on the labour market and on input prices at a time when typically a global slow down would have seen investment tumble between 10-15%.
3. Buffers and Asset prices. Newly indebted households without other forms of income producing assets feel the full force of rate hikes. However, the economy wide impact of interest rates is diluted the more that growth in income producing assets outstrip the growth in debt. The rising trend in net household assets as a share of income over time means that income from term deposits, financial assets and investment property ownership have all risen over time and all produce an income stream which even after 13 rate hikes this cycle is still in excess of the rise in interest payments on the outstanding debt. This explains the bifurcated nature of spending growth. Older asset rich households are largely impervious to the rate hikes and as such luxury spending categories remain strong whereas younger indebted households cashflow has turned negative and spending is being seriously challenged. In aggregate a rate hike pack less of punch compared to prior cycles but the young and indebted are taking a disproportioned beating.
4. Population pump priming. Net immigration has surged well through government projections taking population growth close to 2.5%yoy growth in 2H23. Quite simply, it is very hard to record a recession with that type of population growth at your back. We do expect net migration to slow in 2024 as the government seeks to tighten up some education programs and entitlements, yet the risk remains that the flood of people entering Australia surprises on the upside until a more material rise in the unemployment rate is realised.

Some additional factors are worth noting that support a more positive outlook into 2024 and beyond.

1. Commodity prices are rising again. A falling USD and stronger global demand has seen commodity prices rising in Q4 which will provide a fillip for profits, tax revenue and nominal economic growth.
2. Fiscal support and tax cuts. Despite a change to the details of the Stage 3 income tax cuts, the package is equivalent to 1.0% of disposable income. In conjunction with the Federal Budget in surplus, the RBA rate cycle likely complete and an election looming in 2025 it is likely that addition fiscal support will be announced in 1H24 to support lower and middle income households.
3. Inflation moderation to drive rate cuts. We expect inflation to move into the top of the RBA target band before the end of 2024, setting up the prospect of the RBA easing in August and again in November 2024. While we are expecting a shallow rate easing cycle it will likely come earlier than most expect and importantly the RBA has renewed firepower to drive a more powerful economic recovery should inflation surprise on the downside.
4. Capex intentions have lifted. We were pleasantly surprised to see that the ABS measure of investment intentions rose through 2H23 and now suggests business investment will rise 10% in 2023-24 – well above the RBA's 1-2% forecast. Indeed, not only has business investment been robust, there are signs it is accelerating.

As a consequence, we are relatively optimistic on the outlook for the Australian economy and constructive on the equity market outlook for 2024. We expect economic growth to average 2.25% v a consensus forecast of 1.5%, bond yields to finish the year at 4.0%, the $A/$US to reach 74c, and Australian equities to return 10% in in large caps and 15% in small caps. We are most overweight stocks within the Communication Services, Real Estate and Financials sectors, and are underweight Energy, Consumer Discretionary and Materials.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	10.74	6.59	4.15
Consumer Discretionary	8.36	11.59	-3.23
Consumer Staples	0.66	2.77	-2.12
Energy	0.00	6.64	-6.64
Financials	14.17	12.58	1.59
Health Care	5.10	5.18	-0.08
Industrials	14.56	13.87	0.69
Information Technology	9.82	10.11	-0.28
Materials	19.42	19.91	-0.49
Real Estate	13.58	9.90	3.67
Utilities	0.00	0.87	-0.87

Top 5 holdings

	Portfolio %	Benchmark %	Active %
CAR Group	6.63	2.33	4.30
NEXTDC	5.98	1.57	4.41
Reliance Worldwide	5.15	0.78	4.37
Worley	4.61	1.06	3.55
Netwealth Group	4.27	0.46	3.81

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
NEXTDC	5.98	1.57	4.41
Reliance Worldwide	5.15	0.78	4.37
CAR Group	6.63	2.33	4.30
Underweights			
WiseTech Global	0.00	2.95	-2.95
REA Group	0.00	1.64	-1.64
Ampol	0.00	1.63	-1.63

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	12.21	5.52	7.48	7.22
Distribution return	0.87	1.11	0.93	0.95

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$103.1 mn as 31 March 2024
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

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