YARRA CAPITAL MANAGEMENT

Investment Commentary
Quarter to 31 March 2024

Yarra Ex-20 Australian Equities Fund

Gross returns as at 31 March 2024

	From 25 June 2018^	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception % p.a.*
Yarra Ex-20 Australian Equities Fund	7.19	4.54	9.40	15.53	11.02	9.79	7.41	8.36
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	7.09	4.28	8.31	15.26	8.04	8.15	N/A	N/A
Excess return (before fees)‡	0.09	0.25	1.09	0.28	2.98	1.64	N/A	N/A

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

	From 25 June 2018^	1 month %	3 months %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Since inception % p.a.*
Yarra Ex-20 Australian Equities Fund	6.22	4.46	9.16	14.50	10.03	8.81	6.27	7.15
S&P/ASX 300 ex S&P/ASX 20 Accumulation Index#	7.09	4.28	8.31	15.26	8.04	8.15	N/A	N/A
Excess return (after fees)‡	-0.88	0.17	0.84	-0.76	1.99	0.66	N/A	N/A

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.

^ **Effective 25 June 2018 the Fund's investment strategy, name and benchmark was changed. Performance prior to 25 July 2018 is provided here for consistency purposes only – the historical performance data shown relates to the previous strategy and should not be used to assess past or future performance of the Fund. Performance data relating to the previous strategy is available upon request. 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 Ex-20 Australian Equities Fund: August 2010.

The benchmark for the Yarra Ex-20 Australian Equities Fund has been amended since the Fund's inception. Effective 25 July 2018, the benchmark is the S&P/ASX 300 ex S&P/ASX 20 Accumulation Index, replacing the S&P/ASX 300 Accumulation Index.

‡ Excess return: The difference between the Fund's return and the benchmark return.

Market review

The Australian equities market strengthened during the first quarter of 2024.

The S&P/ASX 300 Ex-20 Accumulation Index gained 8.4% for the quarter, taking its 12-month return to 15.3%. In comparison, the broader ASX300 returned 5.4% for the period. On a global scale, the MSCI World Index also generated a +8.5% return.

Financials (+14.2%) was the strongest performing sector with QBE Insurance (QBE, +21.9%) and Suncorp (SUN, +20.9%) leading the gains. 1H24 results were the drivers of strong performance, with QBE Insurance reporting lower than budgeted claims figures, while Suncorp reported a 14% increase in earnings.

Information Technology (+23.2%) was another strong performing sector with NextDC (NXT, +29.6%) the main contributor. The data centre owner posted strong 1H24 results, exceeding market expectations.

In contrast, Materials (0.4%) was the worst performing sector with Lynas Rare Earths (LYC, -20.5%) and IGO (IGO, -20.8%) the main detractors. Poor H124 results was a big factor in the declines, with Lynas Rare Earths reporting a 74% decrease in net profit while IGO's revenue fell 19% during the period.

Key Contributors

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.

ResMed (RMD, overweight) – the medical equipment company outperformed during the period following its second quarter result. ResMed reported an increase in revenue of 12% ahead of consensus expectations. Despite the focus on GLP-1 risk, we expect RMD to deliver another quarter of robust top line growth, driven by masks/accessory sales. Given the elevated COGS inflation we are expecting minimal uplift in gross margin 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.

Key Detractors

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.

Nine Entertainment Co. (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.

Tabcorp (TAH, Overweight) – the wagering operator underperformed during the period following a poor 1H24 result. The business has been impacted by challenging conditions in the domestic wagering market, with turnover down -4% across both retail and digital channels coupled with a step up in operating expenses. While trading has remained soft in 2H24, TAH have retained share and will benefit from a market recovery as consumer pressures moderate.

Key Purchases

Bapcor (BAP) - we initiated a position in the automotive supplier, reflecting our view that BAP's trade and wholesale businesses remain attractive despite a period of management turnover. While Autobarn has been impacted by a softer consumer, Bursons has remained relatively resilient despite a deferral of service volumes and retains an entrenched position within the aftermarket category. With the stock trading at discount to history (14.7 times FY25 P/E vs 18.2 times 10-year average), this valuation does not capture the growth opportunity on offer and represents an attractive entry point despite some near-term uncertainty.

Liontown Resources (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.

Iluka Resources (ILU) - we took the opportunity to add to our existing position in the mineral sands company during the period. The company's FY23 result gave us increased confidence that green shoots are emerging in the company's zircon and titanium dioxide markets. 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 would be a critical component producer for the EV industry.

Pexa (PXA) – we took the opportunity to add to our existing position in the digital property settlement exchange, whose core Australian exchange has been discounted following faltering expansion attempts into the UK market and data adjacencies domestically. Valuing PXA's UK and Digital Growth business at zero, PXA's Australian Exchange is trading on only 16.5x EV/EBITDA which we see as an attractive entry point into a high-quality business.

Key Sales

Stockland (SGP) – we exited our position in Stockland over the quarter. SGP has traded well supported by expectations of improvement in residential end markets towards the back end of this CY, reducing the upside to valuation, we continue to like the SGP strategy of pushing further into capital partnering, and lifting ROIC for shareholders. Proceeds have been re-allocated to superior risk-return ideas within the real asset sectors.

Region Group (RGN) - With upside to our target price reduced, we exited our RGN position with the stock now trading up to within 5% of its net asset backing (NTA) and the resilience of the portfolio (predominantly supermarket and non-discretionary retailers) better understood and valued by the market.

Link Administration Holding (LNK) – the portfolio's position in third party administrative and share registry service company performed strongly during the period following a Board approved cash bid for the company by Mitsubishi UFJ Trust & Banking Corporation at $2.26, a 33% premium to LNK's prior closing price. With the stock trading close to terms, we have taken the opportunity to deploy capital elsewhere.

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.

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.

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.

Key Active Underweights

James Hardie (JHX) – we retain an underweight position in the leading building materials supply company. Notwithstanding a number of quality aspects to JHX's business (i.e., share growth, a responsive operational and manufacturing footprint) we remain cautious on the ongoing strength in end markets for JHX (a portion of discretionary renovation spend, often labelled as remodelling activity) as well as the impact of normalising input costs on margins. These factors make earnings beats less likely in future periods in our view, making it difficult to support upside in the stock at current valuation of 23.8-times FY24 P/E. Our preferred building material company remains Reliance Worldwide (RWC), which trades on 19.7--times forward earnings.

Brambles (BXB) – we remain underweight the global provider of pallet pooling solutions to various FMCG producers. Supported by a favourable pricing environment, Brambles currently has strong operating momentum with improving free cash flow. Looking forward however, we are cautious on the sustainability of the current high level of profit growth as customer demand and pricing dynamics normalise. Stock valuation in this environment (19.1-times FY24 P/E) looks to capture the remaining upside.

Cochlear (COH) – we remain underweight the global producer of hearing technologies. While we like the strong underlying ear implant demand outlook – supported by COH's ongoing investment into clinical awareness – we are conscious that COH's key developed, and emerging markets have now largely recovered following COVID as hospital capacity issues have normalized. Additionally, the upside from the successful product upgrade cycle (Nucleus 8 sound processor) is now well understood, making the valuation case difficult with the stock trading on 49.9-times FY25 P/E.

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, Utilities and Consumer Discretionary and underweight Real Estate, Industrials and Energy.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	11.93	4.80	7.14
Consumer Discretionary	11.82	7.81	4.02
Consumer Staples	0.00	3.44	-3.44
Energy	0.00	3.83	-3.83
Financials	10.47	13.51	-3.04
Health Care	5.90	9.66	-3.76
Industrials	8.57	13.03	-4.46
Information Technology	10.69	7.89	2.80
Materials	19.84	21.32	-1.47
Real Estate	5.72	11.45	-5.73
Utilities	8.63	3.28	5.35

Top 5 holdings

	Portfolio %	Benchmark %	Active %
ResMed	5.90	1.85	4.05
CAR Group	5.26	1.41	3.85
Origin Energy	5.14	1.64	3.51
NEXTDC	5.00	0.95	4.06
Xero	4.51	1.94	2.57

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
NEXTDC	5.00	0.95	4.06
ResMed	5.90	1.85	4.05
Reliance Worldwide	4.38	0.47	3.91
Underweights			
James Hardie Industries	0.00	2.78	-2.78
Brambles	0.00	2.33	-2.33
Cochlear	0.00	2.29	-2.29

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	13.15	7.84	6.61	3.69
Distribution return	1.35	2.19	2.20	2.58

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 through exposure to Australian Securities Exchange listed securities excluding the largest 20 by market capitalisation (as defined by the S&P/ASX 20 Index). In doing so, the aim is to outperform the S&P/ASX 300 ex S&P/ASX 20 Accumulation Index over rolling 3-year periods.
Recommended investment time frame	5 - 7 + years
Fund inception	August 2010
Fund size	A$48.5 mn as at 31 March 2024
APIR code	JBW0052AU
Estimated management cost	0.90% p.a
Buy/sell spread	+/- 0.15%
Platform availability	BT Panorama, Praemium, Hub24

Applications and contacts

Investment into the Yarra Ex-20 Australian Equities Fund can be made by Australian resident investors only.

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