YARRA CAPITAL MANAGEMENT

Investment Commentary
Month to 30 November 2022

Yarra Australian Equities Fund

Gross returns as at 30 November 2022

	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	6.62	6.52	6.84	5.85	7.06	9.31	10.54
S&P/ASX 200 Accumulation Index†	6.58	6.04	5.00	5.92	8.19	9.37	9.26
Excess return (before fees)‡	0.04	0.47	1.84	-0.07	-1.14	-0.05	1.29

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 November 2022

	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	6.54	6.28	5.89	4.91	6.08	8.30	9.54
S&P/ASX 200 Accumulation Index†	6.58	6.04	5.00	5.92	8.19	9.37	9.26
Excess return (after fees)‡	-0.04	0.24	0.89	-1.01	-2.11	-1.06	0.29

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

Australian equities delivered another month of strong performance, gaining a further 6.6% in November following the 6.0% recovery in October.

The S&P/ASX 200 Accumulation Index returned 6.6% for the month, taking its 12-month return back into positive territory of 5.0%. The broader ASX 300 Accumulation Index mirrored similarly, gaining 6.5% for the month with global indices also strong (MSCI World Index +7.0%).

All sectors delivered positive returns for the month, with Utilities (+20.9%) the best performing sector, led by Origin Energy (ORG, +41.1%) off the back of a takeover bid, and further supported by AGL Energy (AGL, +16.9%) and APA Group (APA, +6.5%).

Within Materials (+16.3%), Metals and Mining produced some of the top performers for the month with Sandfire Resources Limited (SFR, +45.2%), Champion Iron Ltd (+39.0%) and Fortescue Metals Group Ltd (FMG, +31.8%) reflecting strong commodity performance as expectations increased of China reopening creating a stronger demand environment.

Conversely, the lagging sector was Communication Services (+2.1%), with strong returns from Carsales.com (CAR, +12.4%) balanced out by negative returns from Domain Holdings (DHG, -8.4%) and EVT Limited (EVT, -7.5%).

Portfolio review

Key Contributors

Origin Energy (ORG, overweight) – the energy company disclosed a takeover approach from Brookfield and EIG at $9.00 per share, a 55% premium to the pre-disclosure share price, valuing the company at an enterprise value of $18.4b. Talks had been ongoing since August and the indicative approach at $9.00 has been recommended by the Board. We remain attracted to Origin's privileged energy assets and retail position, noting that the deal will be subject to FIRB and ACCC approval, with the latter subject to a public review.

Sandfire (SFR, overweight) – the copper producer was a positive contributor to the portfolio during the period. Copper prices increased 9% over the month to close at US$3.73/lb. We like copper as a commodity given its leverage to electrification as a key material in batteries and electric motors. In addition, the company undertook an equity raising during the period which was well received by investors. We participated in the company's $200m Entitlement Offer during the period and view the raising as an important de-risking event for the balance sheet. The company is now better funded to complete the Motheo project in Namibia, and progress drilling activities to increase the mine life at the MATSA asset in Southern Spain. Further de-risking of these projects, coupled with the positive outlook for copper markets, will continue to generate share price outperformance in our view.

National Australia Bank (NAB, underweight) – the banking sector underperformed during the month as their full year results and outlook commentary for the year ahead indicated that they are rapidly approaching the peak benefit from higher interest rates. Further, the cost outlook for banks has deteriorated which, along with bad debts normalising, likely means that earnings will peak in the first half of FY23.

Key Detractors

Aristocrat Leisure (ALL, overweight) – the gaming company underperformed during the period following a slightly disappointing result, which saw Digital momentum slow more than expected after an initial rally through October. We retain a positive view on the company given ALL's dominant position in Land-Based gaming and expect that Digital revenues will likely normalise after a period of outsized growth. Longer term, we see significant opportunities across both divisions and retain conviction in ALL's growth potential.

Fortescue Metals (FMG, underweight) – the iron ore producer was a detractor during the period as the stock outperformed on rising iron ore prices. During November, the benchmark 62% Fe index rose 27% to close at US$101/t on expectations that a shift away from COVID-zero policies in China would support industrial production and housing starts. As a high-cost iron ore producer, Fortescue is highly levered to movements in spot iron ore prices. We continue to view iron ore prices as unsustainably high relative to cost curve support, particularly in light of November's commodity price rally. As a result, we are happy to remain underweight FMG. BHP is our preferred exposure to iron ore given higher grades, lower operating costs, and a diversified commodity base.

Reliance Worldwide (RWC, overweight) – the plumbing supplies company underperformed during the period following JHX's (ASX-listed peer) weaker than expected market update. The market is showing concern for a falling demand environment and RWC FY23 estimates were lowered after the August result. We believe RWC's reaction to JHX's update is un-warranted. We believe RWC is a compelling opportunity with the market pricing for a significant decline in earnings (P/E of only 12 times vs. 17 times mid-cycle) while we remain constructive on the demand environment given the defensive nature of the majority of RWC's repair and remodelling sales.

Key Purchases

Xero (XRO) – we took the opportunity to buy into XRO following it's weaker than expected 1H23 result given the longer-term attractiveness of the outlook and supportive valuation levels. XRO underperformed after its 1H23 result as the market digested the news of an unexpected CEO changeover, a large EBITDA miss of 23% versus consensus which was due to stronger than expected cost growth below the gross margin line (38% cost growth versus 30% revenue growth), and weaker momentum in net new subscribers in the US, UK, and ROW. The outlook for subs growth in 2H23 is for a rebound in the US and UK (different issues) and more controlled costs. Longer term, XRO should benefit from further cloud migration in international markets, stronger take-up of platform revenues across all geographies, and stronger sub growth in the UK driven by the MTD legislation. After the tech sell-off, the current valuation levels (Market Cap/LTV) have not been seen since late 2017, providing an attractive valuation to be long XRO with a long-term outlook.

Evolution Mining (EVN) – we increased our position in the gold producer during the period. Following a period of significant underperformance relative to listed gold peers due to disappointing production levels and guidance downgrades, we now see attractive value support for EVN. While gearing levels – around 30% – are higher than peers, the risk of an unexpected capital raising to support the balance sheet considerably over-played in our view. AUD denominated gold prices remain robust, and we continue to see price support for gold in the near-to-medium term.

JB Hi-Fi (JBH) – we increased our position in the specialist retailer during the period. We view JBH as a best-in-class operator that is well positioned to navigate the volatility ahead in spite of a softening consumer environment, with strong cash generation and a robust balance sheet. Unlike other Covid beneficiaries, consensus earnings already reflect a 30% earnings decline over the next three years, resulting in JBH trading at a discount vs. history which we believe is unwarranted (8 times EV/EBIT vs. 10 times long-term average).

Key Sales

James Hardie (JHX) – we exited the remainder of our position in the building materials company following a review of expectations around the sustainability of earnings through a more challenging residential environment. While 65% of JHX's end market in the US is exposed to the more resilient Repair & Remodel end market, we note it is heavily skewed to remodelling activity where we see a more challenged outlook to come due to the impact of higher interest rates following a period of strong demand through the more 'stay at home' era that Covid has created. Notwithstanding an undemanding current trading multiple of approximately 13 times forward earnings (PER), we see downside risk to consensus earnings expectations.

Atlas Arteria (ALX) – the portfolio's position in the toll road owner was reduced during the month after appreciating sharply on no new information. ALX is now trading close to an enterprise value equivalent to where it was trading before it undertook its acquisition of the Chicago Skyway toll road.

Tabcorp (TAH) – we exited our position in gambling company during the period. While we were encouraged by the digital opportunities presented to TAH post demerger, we remain wary of the impact of an increasingly competitive wagering market and the associated pressure on margins from new market entrants. We place less upside risk on potential new license wins for TAH, reducing a potential catalyst and believe better opportunities can be found elsewhere.

Key Active Overweights

Link Group (LNK) – despite the uncertainty created by the failed takeover bid from Dye & Durham and regulatory action on its Fund Solutions business, we still see considerable value in LNK's constituent parts and a pathway to crystalising this value. In the interim LNK's two main operating businesses are performing well with two upgrades to guidance provided in the last six months.

Aristocrat Leisure (ALL) – our positive investment view remains premised on ALL's dominant position in Land-Based Games and significant opportunities from Digital. We see the near-term normalisation in Digital as temporary and expect a return to growth over the medium term. ALL remains undervalued at 19 times forward earnings (below the Industrials Ex-Financials multiple) when considering ALL's superior long-term growth potential and balance sheet optionality, with the potential for accretive M&A and/or capital management.

Reliance Worldwide (RWC) – we think the plumbing supplies company is a compelling opportunity, with the market pricing for a significant decline in earnings (P/E of only 12 times vs. 17 times mid-cycle) while we remain constructive on the demand environment (both in the trough and longer term) given the defensive nature of the majority of the company's repair and remodelling sales. Approximately 80% of RWC's sales are repair and remodel, which is not tightly correlated with the housing sector.

Key Active Underweights

CSL (CSL) – we remain underweight CSL based on the challenges the business faces returning to pre-COVID profitability, coupled with its forward valuation (35.4 times P/E and 20.8 times EV/EBITDA on a 12-month forward basis), which we believe appropriately captures the earnings outlook at this time. While CSL is a key beneficiary of the post-COVID re-opening theme from a plasma collection perspective, we believe this is already reflected in consensus forecasts. However, in our view the prospect of higher costs going forward is underappreciated by the market, with donor fees and other collection centre costs likely to be higher for longer. We continue to prefer ResMed (RMD) within the Health Care sector, where we see better growth prospects and a strong competitive position versus peers.

National Australia Bank (NAB) – we remain underweight the bank reflecting our negative sector view. The favourable dynamics around expanding net interest margins (NIM) due to higher interest rates are now well understood, and we do not expect the gains to be sustained into the medium term. Further, the banks are facing material earnings offsets through elevated expense growth and a normalization in bad debt expenses which will mean sector EPS is likely to be approaching peak levels. We hold small overweight positions in Westpac Bank (WBC) and ANZ Bank (ANZ), where the valuations are more supportive at current levels.

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 see as unsustainable into the medium term. We see significant downside risk to consensus forecasts beyond FY23, which currently reflects a strong contribution from lumpy items including gains on sale, performance fees and low loan-loss provisions. We do not expect growth in the more stable business to be able to offset this. As a result, we regard MQG's headline forecast P/E multiple of 15.9 times consensus forward earnings as unattractive.

Market outlook

Financial markets have now embraced the risk of recession in the US and Europe over the past quarter, and the gap between our more pessimistic forecasts for the global economy and the consensus has narrowed. Indeed, with markets anticipating the end of the Fed tightening cycle may be at hand, financial conditions have eased considerably in the US as credit spreads narrowed, the equity market rallied strongly in October and November and the US$ declined.

The period of excess inflation is starting to recede, with prior surges in commodity prices retreating, an easing in supply constraints, and signs of slowing demand likely to compress elevated sales margins. As central banks continue to await firmer signs that inflation expectations have stabilised and for labour demand to ease, financial markets are faced with the positive news of less restrictive monetary policy and the negative news of likely weaker company earnings.

In a world of heighted concerns of recession in major developed economies, subdued economic activity in China and ongoing conflict between Russia and the Ukraine which has contributed to commodity shortages, high inflation and rising interest rates, the Australian economy presents as a relative safe haven.

Australia's economic data has remained robust in in the first three quarters of 2022, although we do expect economic activity to slow significantly in 2023 to average just 1.5%. While a local recession is possible in 2023, we believe Australia should be able to avoid a technical recession due to three key reasons:

1. Australia has been a net beneficiary of global commodity shortages. This surge in commodity prices saw Australia's export prices in A$ terms move to their highest levels since the 1880s in 1H2022. The consequence has been strong national income growth, profits growth and an improving underlying fiscal position.
2. The household sector continues to hold a significant buffer of over $260bn of excess savings relative to pre-COVID levels. Although we expect the impact of higher interest rates and higher living expenses will curtail consumer spending, we do expect the combination of rising wage growth and a run down in the level of savings to continue to support consumption spending.
3. Low levels of spare productive capacity, strong profit and low corporate debt have contributed to robust capital investment intentions.

In the medium term we believe a recovery in net immigration levels into Australia and Australia's exposure to key commodities crucial to the global energy transition will provide a solid underpin for future economic growth.

While the RBA has been later than most other developed nations in tightening policy, tighter financial conditions in 2022 have come via both significantly higher cash rates, higher government bond yields and wider corporate bond spreads. Following the December rate hike of 25bps we believe the RBA is now very close to the finish of the tightening cycle. Officially we expect a final 15bps hike in February. Indeed, we believe the RBA inflation forecasts will likely be downgraded slightly in February 2023 which will be used to put a full stop to the current rate tightening cycle. The A$/US$ has finally started to appreciate, after a long period of relative weakness. With Australia's external accounts remaining in excellent health, our expectation that Australia's economic growth will be more robust than its peers and the prospect the US$ uptrend will peak as the Fed pivots from its aggressive hiking strategy we expect the A$/US$ will appreciate to the mid-70s by mid-2023.

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

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	12.20	3.77	8.43
Consumer Discretionary	9.45	6.32	3.13
Consumer Staples	1.43	4.66	-3.23
Energy	6.54	6.29	0.25
Financials	20.37	28.72	-8.35
Health Care	4.47	9.95	-5.48
Industrials	6.77	5.79	0.98
Information Technology	9.36	2.71	6.64
Materials	23.19	24.18	-1.00
Real Estate	0.00	6.13	-6.13
Utilities	2.58	1.46	1.12

Top 5 holdings

	Portfolio %	Benchmark %	Active %
BHP	9.23	10.68	-1.45
Commonwealth Bank of Australia	6.67	8.53	-1.86
Westpac Banking	5.40	3.86	1.54
Telstra	4.33	2.13	2.20
Woodside Energy	3.91	3.28	0.63

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Link Administration	2.91	0.08	2.83
Aristocrat Leisure	3.69	1.08	2.61
Reliance Worldwide	2.60	0.11	2.49
Underweights			
CSL	1.77	6.70	-4.93
National Australia Bank	0.00	4.64	-4.64
Macquarie Group	0.00	3.01	-3.01

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	-4.80	-8.61	-6.66	-1.48
Distribution return	10.70	13.52	12.74	9.78

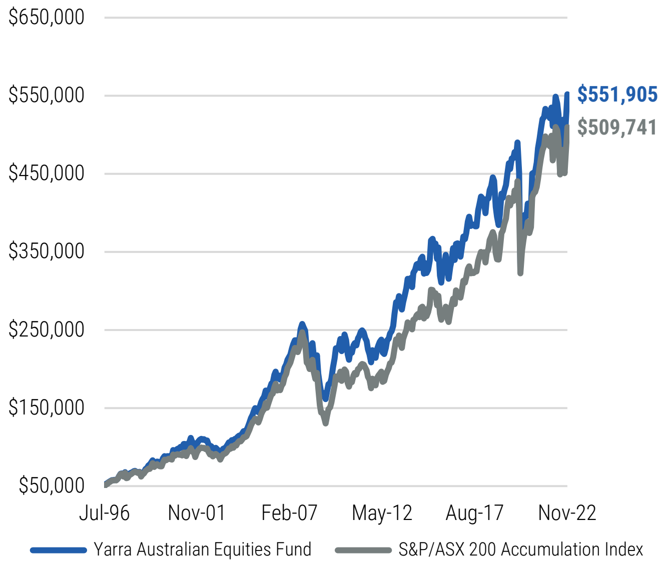
The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders 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$106.9 mn as at 30 November 2022	
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 November 2022.



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.

Website www.yarracm.com

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