YARRA CAPITAL MANAGEMENT

Investment Commentary
Month to 31 July 2024

Yarra Emerging Leaders Fund

Gross returns as at 31 July 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	3.23	0.63	3.43	4.87	7.44	9.69	10.94
Emerging Leaders Combined Benchmark†	3.83	2.62	7.82	2.52	6.31	8.67	7.15
Excess return (before fees)‡	-0.60	-2.00	-4.39	2.35	1.13	1.02	3.79

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 management costs, meaning they do not reflect the deduction of any investment management fees and expenses 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 July 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	3.12	0.31	2.14	3.57	6.12	8.33	9.63
Emerging Leaders Combined Benchmark†	3.83	2.62	7.82	2.52	6.31	8.67	7.15
Excess return (after fees)‡	-0.71	-2.31	-5.67	1.05	-0.19	-0.34	2.49

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* Inception date Yarra Emerging Leaders Fund: September 1997
† 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 month of July.

The Emerging Leaders Benchmark returned +3.8% for the month, taking its 12-month return to +7.8%. By comparison, the broader S&P/ASX 300 Accumulation Index rose 4.1% for the period. Globally, the MSCI World Index also recorded a +1.7% return.

Interest rate sensitive sectors outperformed during July as a cooler CPI result reduced the likelihood of further rate hikes with Consumer Discretionary (+6.2%), Financials (+8.7%) and Real Estate (+5.5%). Within Consumer Discretionary, notable contributors included Harvey Norman (HVN, +14.9%), ARB Corporation (ARB, +11.9%) and Super Retail Group (SUL, +14.5%) while Zip (ZIP, +30.8%) and Pinnacle Investment Management (PNI, +15.7%) drove outperformance within Financials. Waypoint REIT (WPR, +16.6%), National Storage REIT (NSR, +7.4%) and Region Group (RGN, +8.1%) were notable outperformers within Real Estate.

In contrast, Energy (-5.0%) was the worst performing sector. Strike Energy (STX, -28.6%) was the largest detractor following a poorly receive update on status of the gas supply agreement for West Erregulla with Wesfarmers. Boss Energy (BOE, -11.6%) and Lotus Resources (LOT, -23.5%) were also significant underperformers during the period.

Portfolio review

Key Contributors

Pinnacle Investment Management (PNI, overweight) – the fund manager outperformed during the month with limited company specific news. We are seeing an acceleration in revenue growth with material longer term growth potential as inflows reaccelerate across the diverse range of products including from international distribution, performance fees increase from depressed levels and new products mature. Furthermore, margin expansion will be supported by the high fixed cost nature of funds management businesses and new manager formation both organically and via acquisitions will create additional shareholder value.

Reliance Worldwide (RWC, overweight) – the plumbing supplies company outperformed during the month on the expectation of improving sales growth. At current levels, we believe the 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.

Evolution Mining (EVN, overweight) – the gold miner contributed positively during the month due to a 3.6% increase in the gold price and a positive quarterly production update. EVN reported a 14% increase in gold production and 13% reduction in its all-in sustaining cost. We remain attracted to EVN's long-life assets, and meaningful leverage to copper production at the Ernest Henry and Northparkes mines.

Key Detractors

NEXTDC (NXT, overweight) – the data centre owner and developer underperformed during the period mirroring the selloff in US technology stocks linked to growing scepticism around the pace of take up of artificial intelligence technologies. We favour NXT as the company has a unique combination of structural long-term earnings growth driven by the adoption of cloud and artificial intelligence capabilities, combined with infrastructure-like characteristics and solid returns on capital backed by a tangible asset base.

Iluka (ILU, overweight) – the mineral sands company was a modest underperformer during the period on softer than expected rates of recovery in the zircon and rutile markets. The company reported a 2% increase in zircon pricing with its quarterly production report, but rutile prices fell 7% on softening pigment demand. While the recovery is challenged in the near term, we believe ILU remains well placed to capture improving volumes and pricing across the cycle. We remain attracted to ILU's dominant position as a mineral sands producer. While the company's rare earths strategy faces near-term pricing headwinds, we see longer-term optionality.

Lifestyle Communities (LIC) – the land lease community provider underperformed during the month driven by a trading update in which the company withdrew its forward-looking guidance due to the difficulty in quantifying the impact of uncertainty caused by recent media coverage.

Key Active Overweights

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 improved product mix rolls out. We believe this valuation does not 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 vehicle classifieds company which has strong growth potential across Australia (42% revenue), Trader Interactive (25% revenue), and Webmotors (16% revenue). CAR has materially stepped-up investment into product development which should permit further yield growth across all geographies. In Australia, CAR's market position has strengthened in the private segment, in particular. The offshore businesses are less mature and have further runway for growth as key learnings (i.e. dynamic pricing) from the Australian business are applied offshore. The visibility on CAR's medium term revenue growth has improved, and we view the 33.7-times FY25 earnings trading multiple as relatively undemanding given these tailwinds.

Worley (WOR) – we remain overweight the leading provider of global engineering services. While industry activity has slowed after a strong post-COVID recovery, we continue to like the longer-term opportunity for the company. With global energy demand set to grow, demand for traditional oil and gas has increased, alongside sustainability solutions such as carbon capture, utilisation and storage (CCUS). We see the slowdown in spend on sustainability projects being shorter term in nature with a number of global elections being held in CY24. 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

REA Group (REA) – we hold an underweight position to 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). With REA trading on a multiple of 46.3-times FY25 P/E, we see superior risk-adjusted returns in other high-growth online businesses at this time such as Carsales.com (CAR) which trades on 33.7-times FY25 P/E.

Orica (ORI) – we retain an underweight position to the Australian-based explosives 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 (e.g. repricing of 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 16.7-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

Last month we flagged that the end of the 'hope' or P/E expansion phase for equity markets had likely concluded and the transition to the next phase for financial markets would not come without some growing pains in 3Q24. Early August has revealed a bout of those growing pains, prompted in part by the July US labour market figures triggering the Sahm rule and a poor ISM (Institute for Supply Management) report.

Weaker dataflow has seen the risk of recession in the US rise, however from our perspective it is approximately a 30% probability at present. Recession is not our base case and the key difference is that some of the key aspects that generate recession outcomes are not evident currently. Typically, recessions occur due to one of more of the following reasons;

1. **Clear policy error:** While a case can be made that the Fed could have eased in July, it is clear they discussed easing and post recent data they have expressed a greater degree of urgency to act now to forestall a larger than desired easing of the labour market. As such, if the Fed does follow through and act in a timely manner, there is no clear policy error at this point.
2. **A break down in credit provision:** Credit was already tight heading into the August market correction, using the Fed's Loan Officers Survey as a guide. There are risks that a large financial institution could be threatened as the carry trade unwinds, but there is no evidence of a systemic threat to markets at present.
3. **Expectation shocks:** This is the main mechanism that turns economic downswings into recessionary shocks. It's important to note that levels of US business and consumer sentiment are closer to cyclical lows than highs and prior strength in US economic growth was more sourced from fiscal stimulus rather than excess private demand growth. That is, an abrupt expectation shock in the private sector is less likely and as such a sharp retracement in activity growth is also less likely.

Turning to Australia, Australia continues to operate near stall speed. GDP increased just 0.1%qoq, taking the annual rate to 1.1%yoy. Ex-COVID this is the slowest annual rate of growth in 32 years. The RBA remains caught between a weak economy and persistent wage growth and consumer inflation. Nevertheless, Australia's central bank should be buoyed by signs that the decline in productivity appears to have passed and wage pressures appear to have peaked. With respect to the latter, the 3.75% increase in awards, compared to 5.75% in 2023, will help expedite an easing in wage pressures through 2H24.

This month, the RBA assessed that both labour and product markets are slightly tighter than previously thought. Despite a relatively benign CPI print for 2Q24, the RBA clearly remains wary that underlying inflation remains elevated and have little tolerance for any slippage in the timeline to the mid-point of the target band. While we can't rule out the RBA choosing to remain on hold for an extended period, we remain of the view that inflation will finish 2024 inside the RBA's target band of 2-3% and the RBA will commence a modest easing cycle for interest rates in late 2024.

Against this moderation in inflationary pressures, we expect economic growth to accelerate sequentially through 2024, albeit remaining well below 'potential' growth. We expect the upswing in global industrial production to provide a tailwind for Australian economic growth. Investment backlogs should support positive business investment growth and the consumer outlook should be supported by a recovery in real household income growth driven by ongoing wage growth, income tax cuts, cost of living support delivered in the Budget and the commencement of the rate easing cycle later in 2024.

As a consequence, we are relatively constructive on the outlook for the Australian economy and the equity market outlook for 2024-25, even if there are some nearer term headwinds. We expect economic growth to average 1.75% vs. a consensus forecast of 1.3% in 2024, bond yields to finish the year at 4.5%, the $A/$US to reach 72c, and Australian equities to return 10%.

We are most overweight stocks within the Communication Services, Health Care and Real Estate, and are underweight Energy, Consumer Staples and Consumer Discretionary.

Sector allocation

	Portfolio %	Benchmark %	Active %
Communication Services	11.55	6.88	4.67
Consumer Discretionary	8.11	11.68	-3.57
Consumer Staples	0.63	4.40	-3.77
Energy	0.00	6.09	-6.09
Financials	16.31	13.84	2.47
Health Care	9.28	6.44	2.84
Industrials	14.17	14.75	-0.58
Information Technology	6.96	6.23	0.73
Materials	18.96	18.50	0.46
Real Estate	12.72	10.11	2.61
Utilities	0.00	1.09	-1.09

Top 5 holdings

	Portfolio %	Benchmark %	Active %
CAR Group	6.30	2.28	4.02
NEXTDC	5.14	1.74	3.40
Evolution Mining	4.81	1.35	3.46
Worley	4.80	1.23	3.56
Reliance Worldwide	4.78	0.70	4.08

Key active positions

Overweights	Portfolio %	Benchmark %	Active %
Reliance Worldwide	4.78	0.70	4.08
CAR Group	6.30	2.28	4.02
Worley	4.80	1.23	3.56
Underweights			
REA Group	0.00	1.83	-1.83
Orica	0.00	1.51	-1.51
Washington H. Soul Pattinson	0.00	1.51	-1.51

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	0.43	-3.65	1.12	4.76
Distribution return	1.71	7.22	5.00	3.57

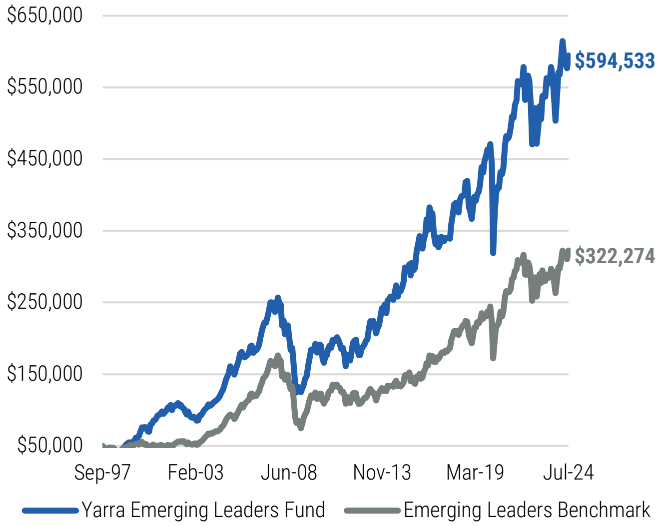
The Growth Return is measured by the movement in the Fund's unit price (inclusive of fees), ex-distribution, and can be positive or negative as the unit price can fluctuate with changes in the underlying market value of the Fund's assets. The Distribution Return is the amount that is paid to unitholders 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	September 1997	
Fund size	A$92.7 mn as at 31 July 2024	
APIR codes	JBW0010AU	
Estimated management cost	1.25% p.a.	
Buy/sell spread	+/- 0.20%	
Platform availability	Asgard Ausmaq BT Panorama BT SuperWrap Financial Index	Hub24 Macquarie Wrap Mason Stevens MLC Wrap OneVue

Investment performance comparison of $50,000

After fees, since inception of the Yarra Emerging Leaders Fund, September 1997 to July 2024.



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 benchmark (comprising 50% S&P/ASX Midcap 50 Accumulation Index and 50% S&P/ASX Small Ordinaries 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.

Applications and contacts

Investment into the Yarra Emerging Leaders Fund can be made by Australian resident investors only.

Website www.yarracm.com

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