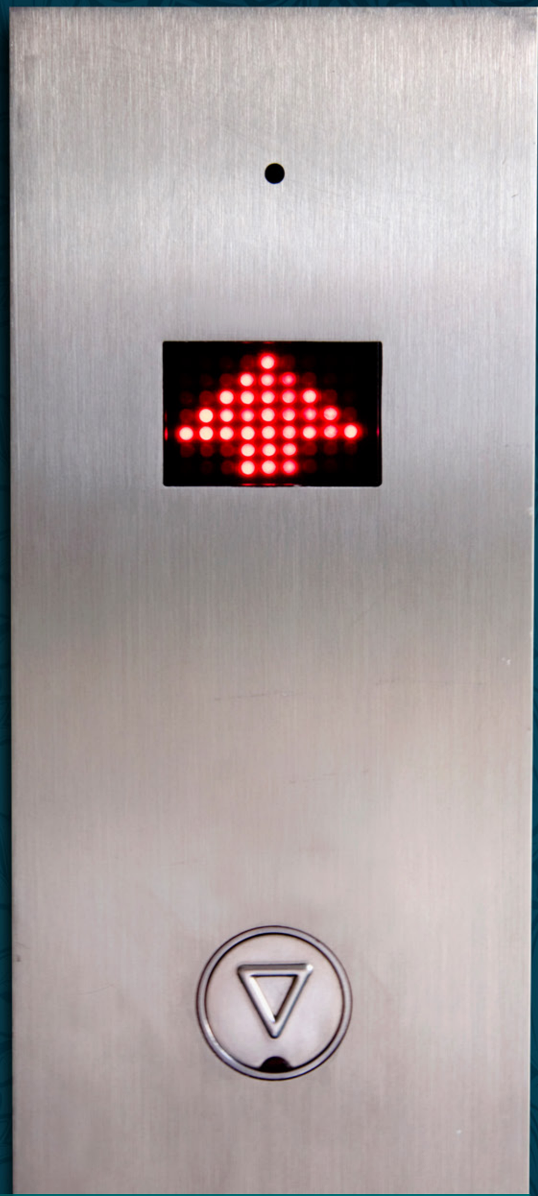
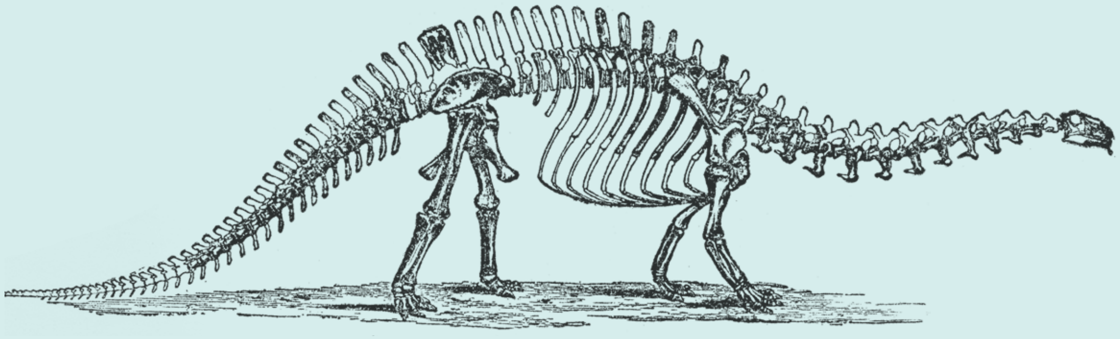
GO BEYOND THE POINT OF LOW RETURNS

Dion Hershan gives us the heads-up on getting more out of the Ex-20.



YARRA
CAPITAL MANAGEMENT



The ASX 200's heavy concentration of resources and banking often results in portfolios dominated by low growth 'dinosaurs' – creating an effective barrier to higher returns. By looking beyond the top 20 and more critically at the ASX 200, active investors can uncover significant opportunities to increase earnings. The Yarra Ex-20 Australian Equities Fund offers exposure to high-growth businesses, future-facing commodities and exporters.

Dion Hershan, Head of Australian Equities

Current earnings landscape

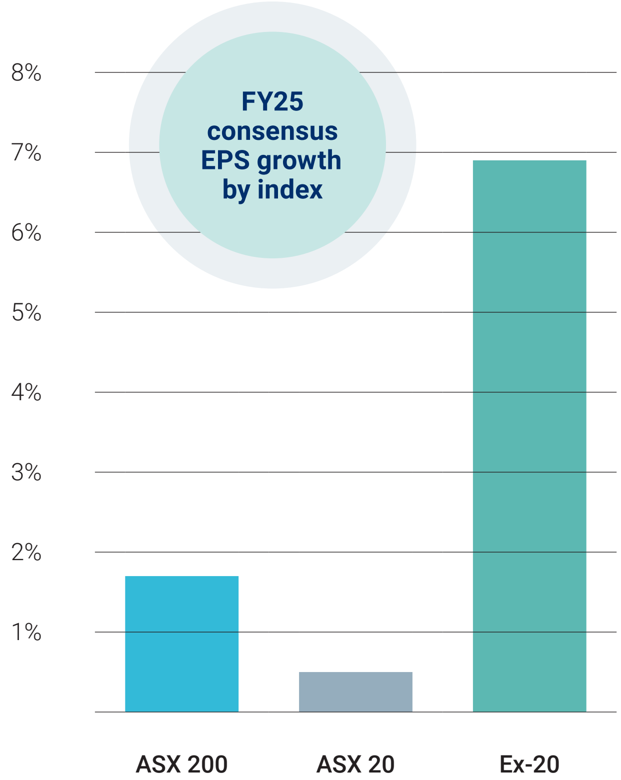
The overall earnings landscape of the Australian equity market remains subdued, marking a second consecutive year of reduced earnings per share (EPS) post the COVID-era peak. This environment is less than ideal for investors seeking growth.

Heavy metal

Banks account for 21% of the ASX 200 benchmark, and iron ore mining companies BHP, Rio Tinto and Fortescue Metals 14%. So for every client dollar added to the ASX 200, roughly one-third in a low tracking error benchmark-aware or passive fund goes into a bank or mining company.

Turn up the volume

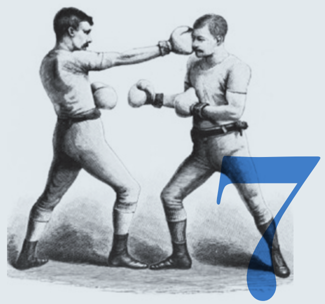
Much of the drag on earnings growth is focused within the ASX 200's top 20 stocks where banking and iron ore's collective heft increases from 35% to 55% of market capitalisation. But do the returns justify this concentration when companies outside the top 20 exhibit much better growth prospects.

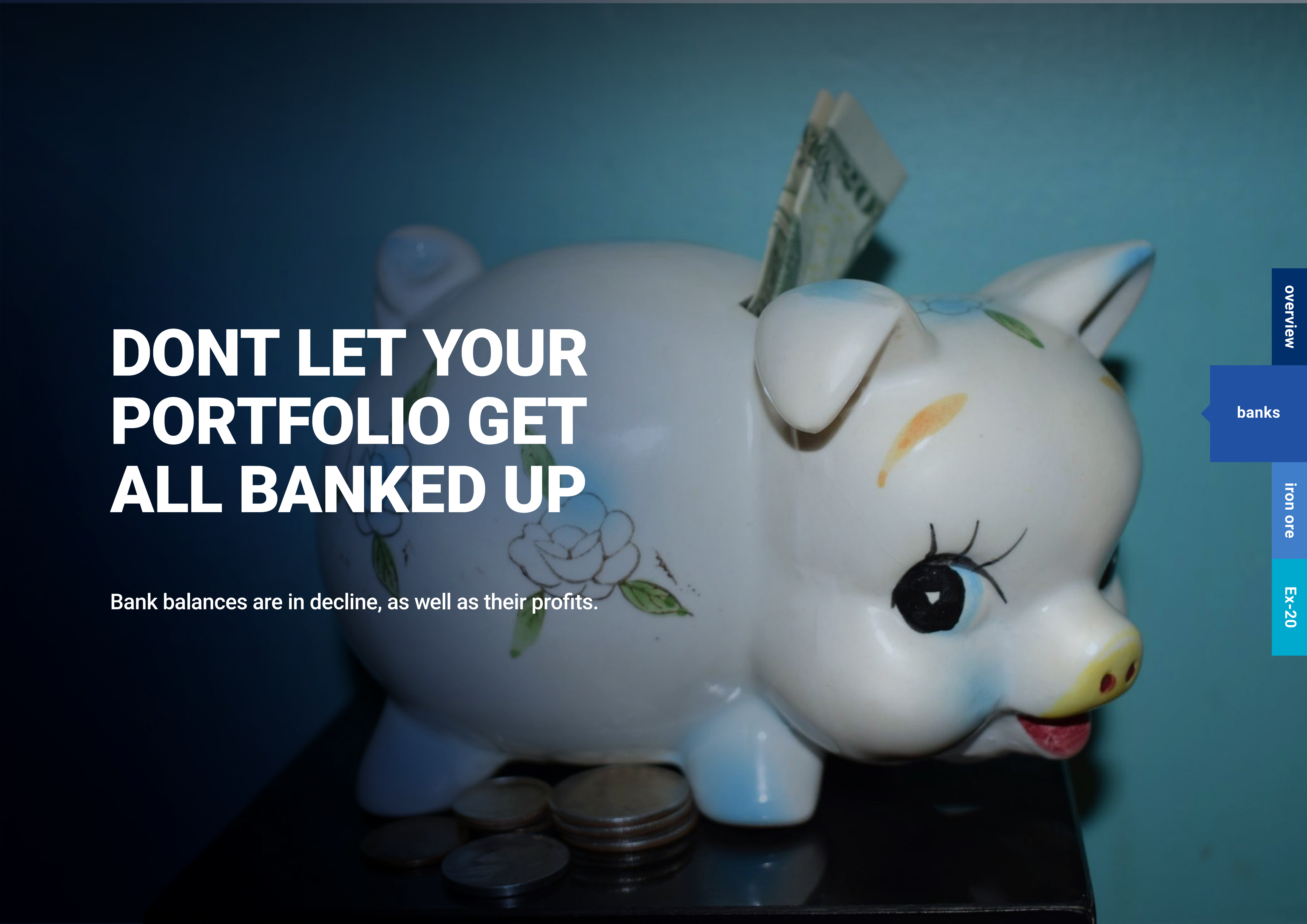


Source: Goldman Sachs, FactSet. As at 30 June 2024.

Magnificent vs mundane

In the US, the 'magnificent seven'; Apple, Amazon, Google, Meta, Microsoft, NVIDIA and Tesla, make up 30% of the S&P 500, driving strong earnings growth and pushing the index to new highs. In contrast, Australia's market is dominated by four banks and three mining companies, with lacklustre earnings growth of -3.5% projected for FY25. In this environment, simply owning the broad market is unlikely to deliver the best investment outcome.



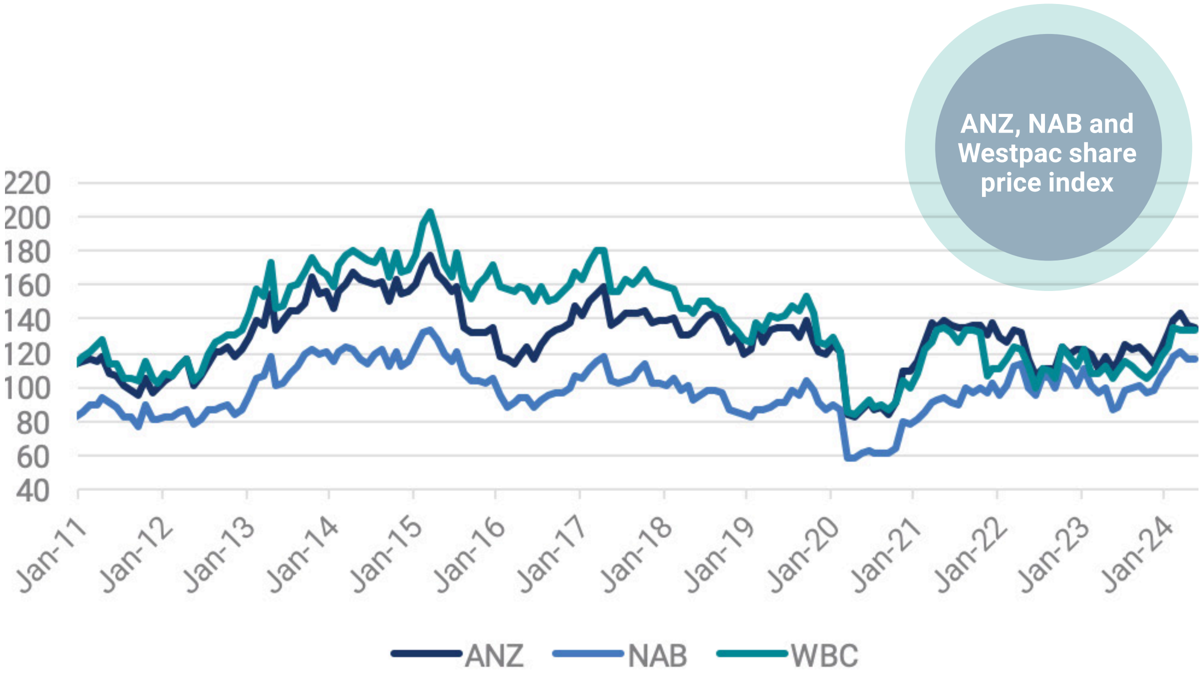


DONT LET YOUR PORTFOLIO GET ALL BANKED UP

Bank balances are in decline, as well as their profits.

A lost decade for the banking sector

Banks peaked in 2017 and EPS is expected to be flat at best in FY25 due to stagnant revenue, rising costs and normalising bad debt expenses. Share prices typically follow earnings, so it's unsurprising that, with the exception of Commonwealth Bank, major bank share prices remain below their 2015 highs.

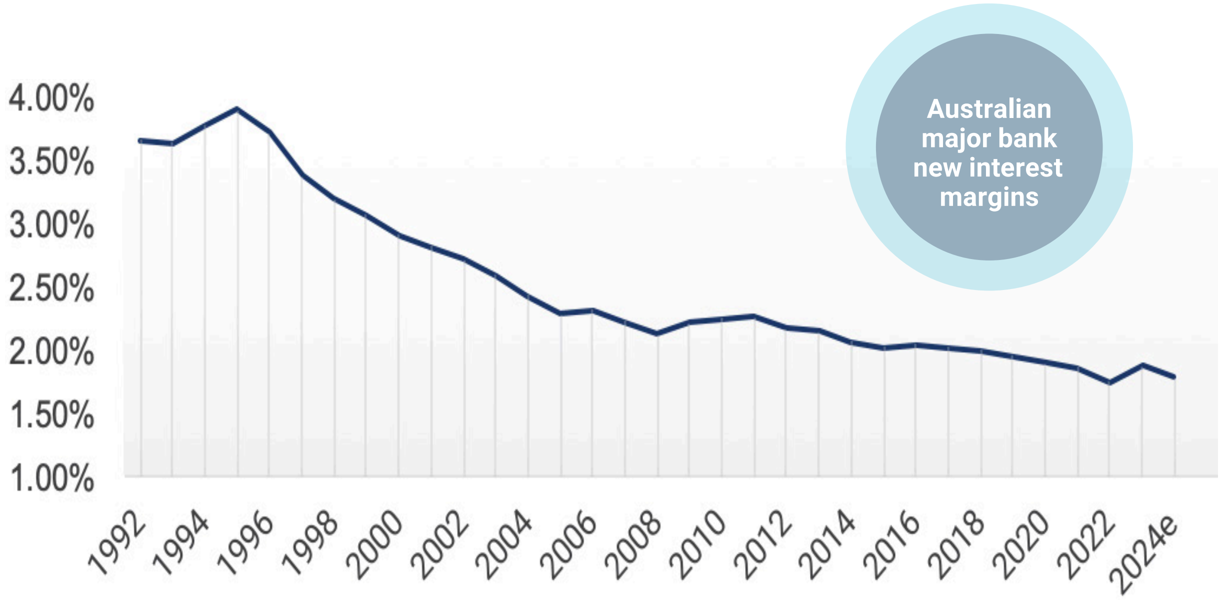


Source: Goldman Sachs, Yarra Capital Management. As at 30 June 2024.

Bank share prices are still trading below highs last seen in 2015

Returns eroded

Over the last decade, the market structure of Australia's banking system has deteriorated significantly. Consumer preferences have shifted towards brokers for property loans, and digitally native competitors have eroded returns in traditionally lucrative areas such as mortgages, consumer finance and foreign exchange.



Source: Yarra Capital Management, Visible Alpha. As at 30 June 2024.

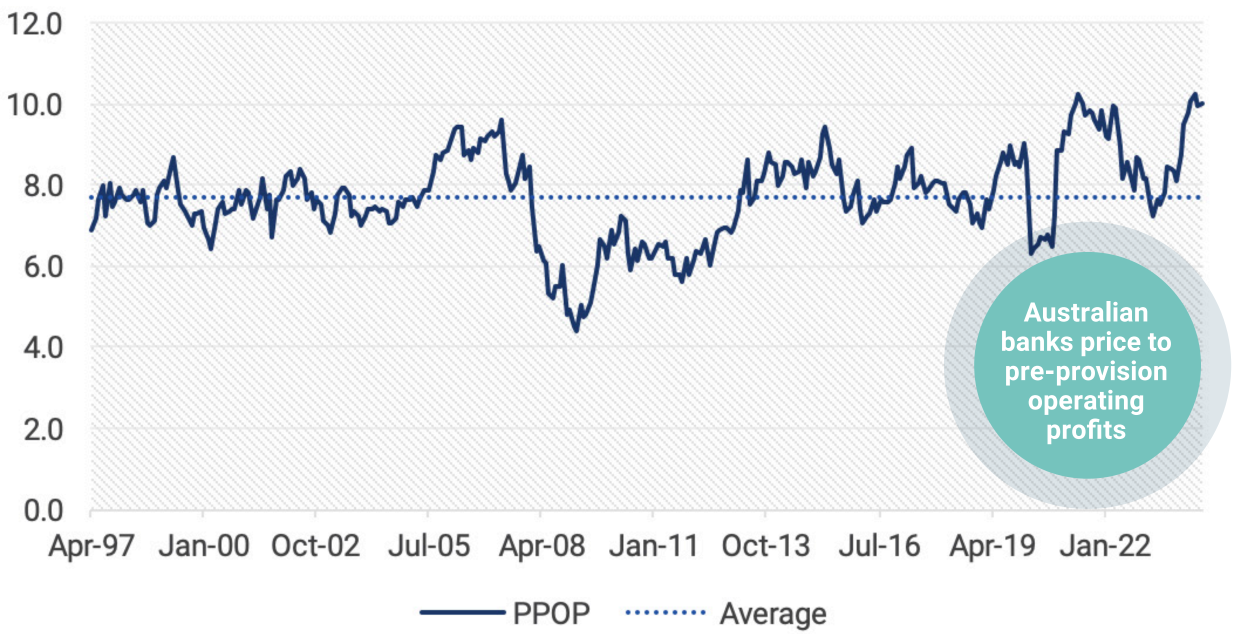
Declining mortgage ROEs

Historically, Australian banks have enjoyed returns on equity (ROEs) of over 20% and double-digit credit growth on mortgages, making them some of the highest performers globally – and great investments.

But with low cost, intermediate players such as Macquarie Group aggressively targeting low risk customers, banks are now struggling to achieve mortgage returns above their cost of capital.

Multiples unjustified by yields

Despite a challenging medium-term outlook and lack of earnings growth, major banks are perversely trading at near-record multiples. When investors can receive a higher term deposit yield from an Australian bank than a dividend yield from owning its equity, it's a strange world indeed.



Source: Goldman Sachs. As at 30 June 2024.

Costs rising faster than incomes

The top-line issues for Australian banks have been compounded by their inability to control their cost bases, with the sector to income ratio deteriorating by 360bps over the last ten years. This is largely due to outdated core systems with decades of accumulated complexity. Despite outlaying nearly $8b annually on 'investment spend', tangible returns on this spend are elusive.

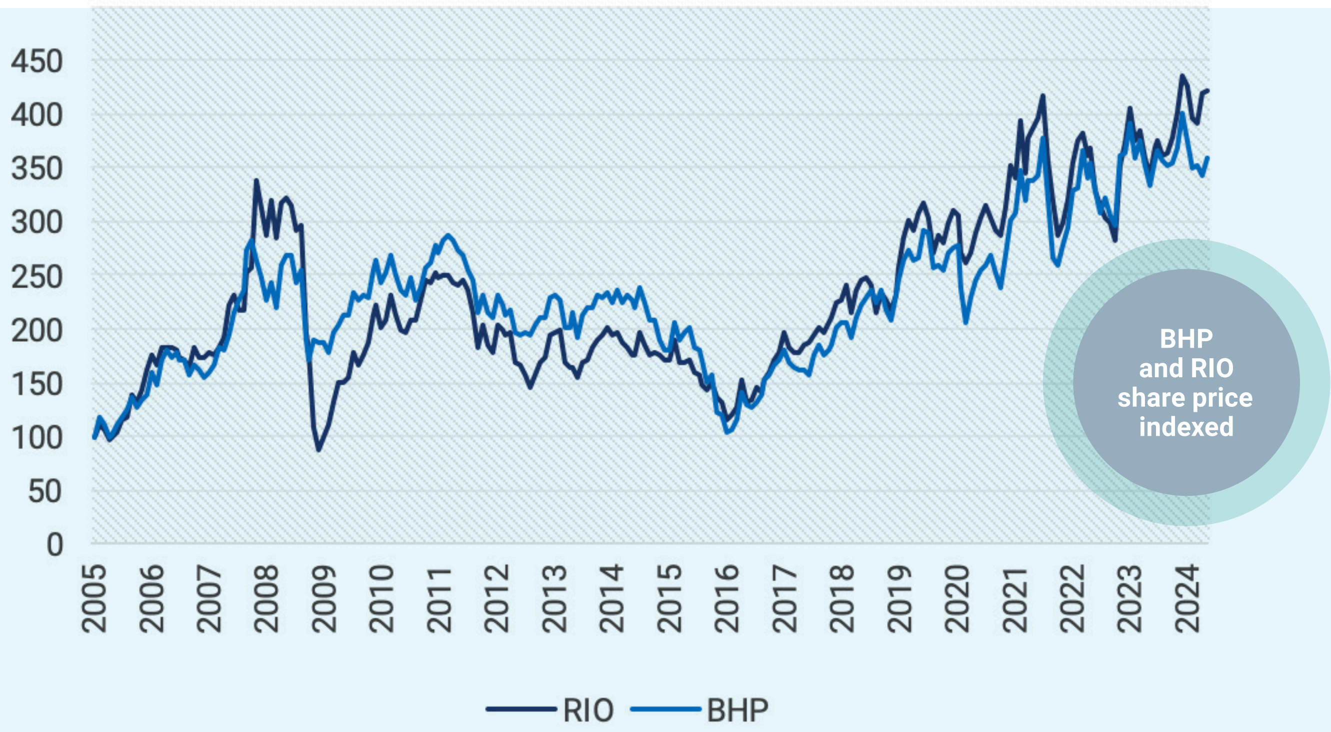
Three of the four major banks recognised the need to improve their expense management and announced absolute cost reduction targets. However, all three have since abandoned these targets without achieving any reduction.

IRON OUT YOUR PORTFOLIO

Global demand for iron ore is running out of steam.

Iron ore is past its peak

Despite the sector's poor track record in mergers and acquisitions, investing in Australia's large iron ore miners was a highly profitable trade during the first two decades of the 21st century. Today, the conditions that drove that success are fading. In China, which accounts for 71% of the global seaborne market, demand for iron ore is stagnating due to a housing sector downturn and a maturing economy.

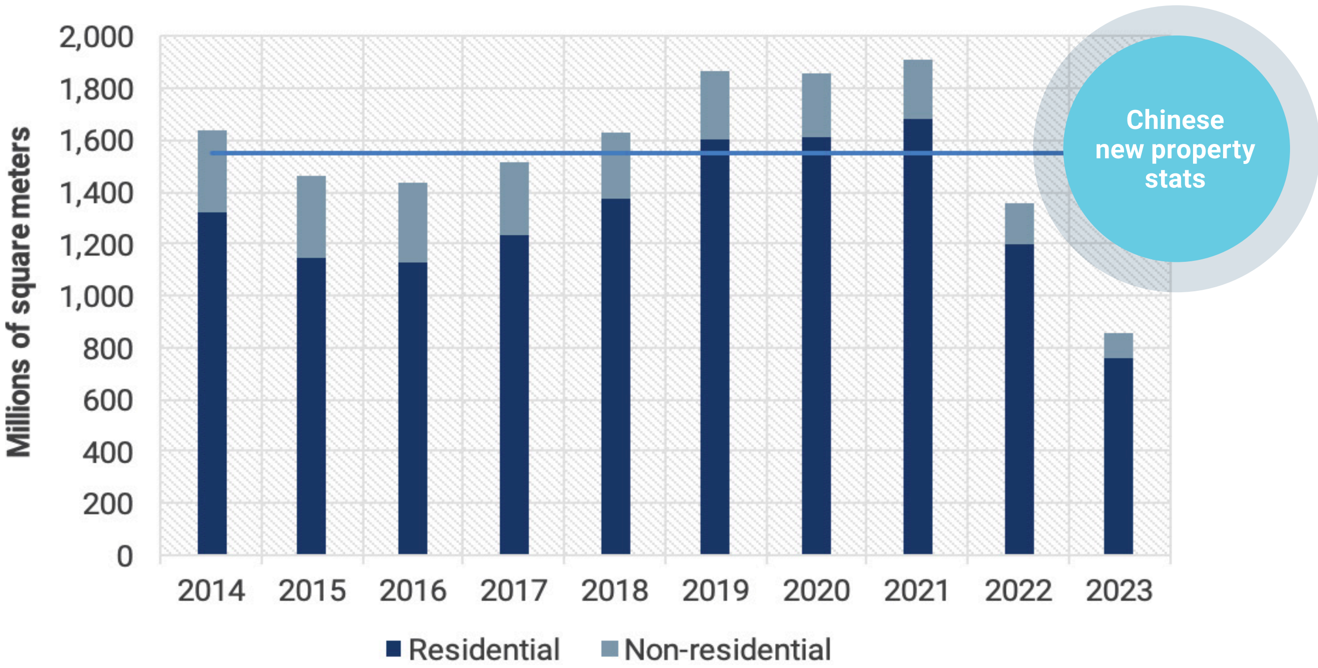


Source: Yarra Capital Management, Eikon. As at 30 June 2024.

Even with the current spot price at less than US$100/t, iron ore remains well above the cost curve despite weakened demand and elevated inventory.

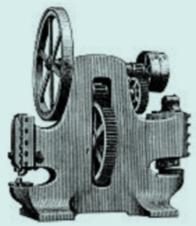
Chinese steel demand has matured

In the post-pandemic period, key sectors driving China's consumption of steel have stagnated. Housing, a long-time favourite for government stimulus and 28% of China's demand, is now facing material oversupply. This reflects not just overbuild, but also difficult demographics and maturing urbanisation trends.

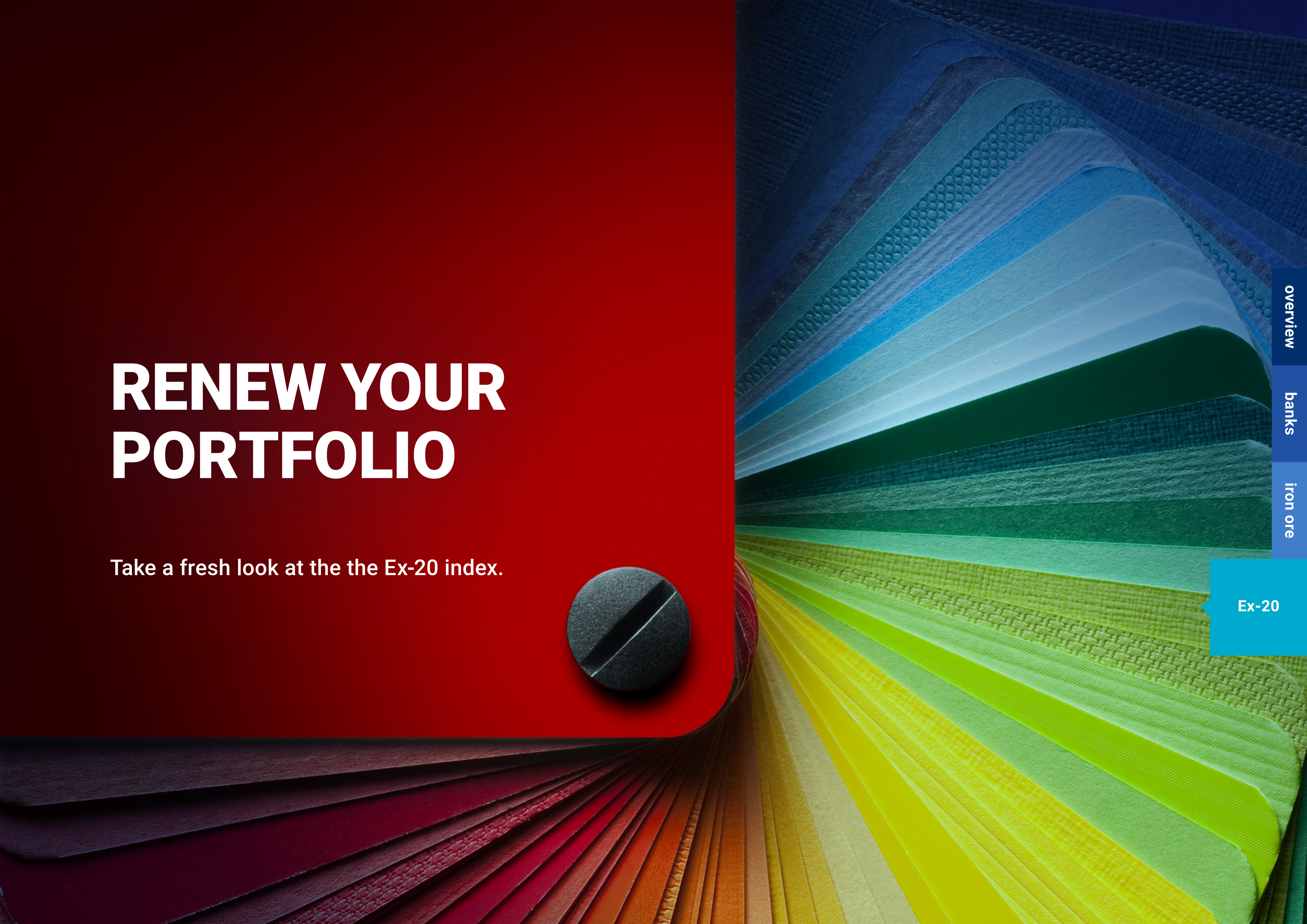


Source: Yarra Capital Management, Bloomberg. As at 30 June 2024.

Housing starts have declined sharply, falling 45% below the 10-year average and 55% below peak levels.



While infrastructure and auto manufacturing have grown in line with the broader Chinese economy, they have not offset the decline in housing-related steel demand. Even if Chinese housing starts to recover, the rapid growth seen in the early 2000s will not return.

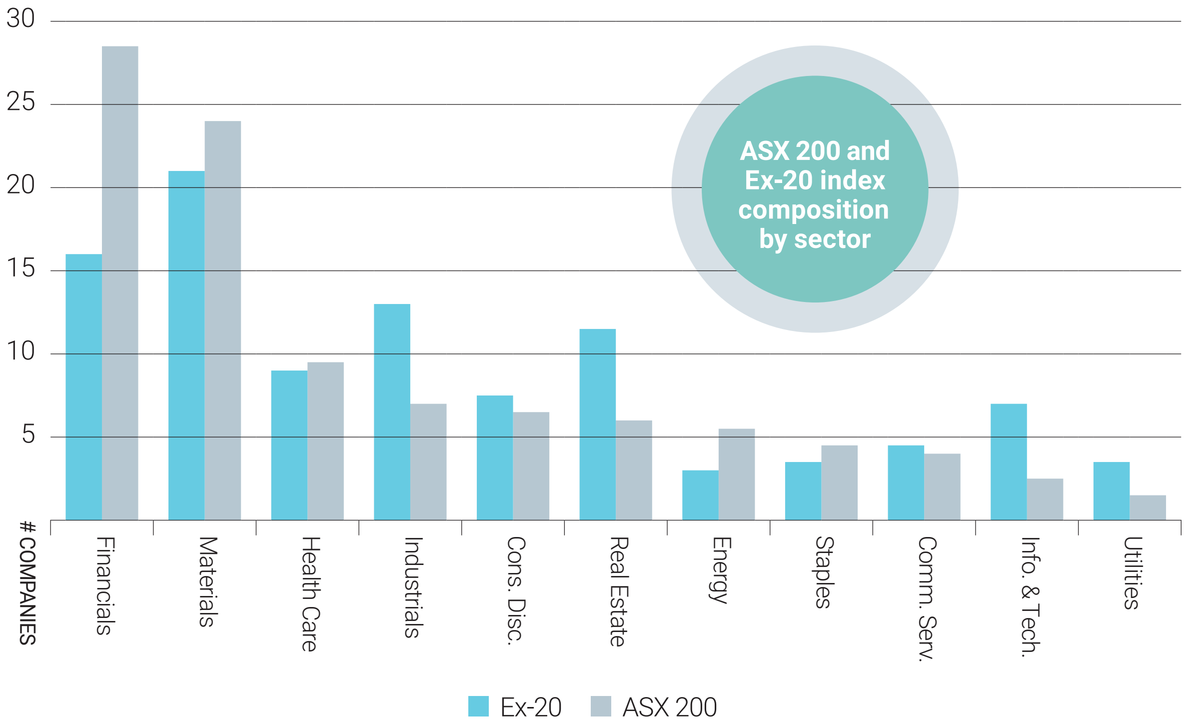


RENEW YOUR PORTFOLIO

Take a fresh look at the the Ex-20 index.

Superior returns with the Ex-20

With the four banks and three mining companies that dominate the ASX 200 expected to deliver -0.6% earnings growth in FY25, smart investors need to diversify with new alternatives.



Source: Yarra Capital Management. As at 30 June 2024. Compound annual growth rate (CAGR).

Uncover an extra 5.2%

In the medium term (3-year CAGR), the Ex-20 benchmark shows stronger earnings growth at 6.9% compared to the ASX 200's 1.7%.

It has only a modestly higher PE multiple of 17.5x versus 16.4x for the ASX 200, making it a more attractive option for investors.

Higher returns and less volatility

The Ex-20 benchmark has consistently outperformed its peers over time, offering strong returns and better risk-adjusted performance.

It also has a much greater investable market cap (over two times), more liquidity, less volatility, and lower fees than smaller companies.

Indices	Return percentage			Capitalisation $Bn	Annualised volatility
	10 year	Capital	Dividend		
ASX 200	8.1	3.7	4.4	2,347	14.0
ASX 300 ex 20	**8.8**	**5.4**	**3.5**	**966**	**15.5**
ASX 200 ex 50	9.1	58	3.3	494	16.3
Smalls	6.5	3.4	3.1	405	17.2

Returns	1 year	3 years	5 years	10 years	20 years
ASX 200	12.1	6.4	7.3	8.1	8.6
ASX 300 ex 20	**7.5**	**4.0**	**5.9**	**8.8**	**8.0**
ASX 200 ex 50	8.2	2.4	6.8	9.1	8.5
Smalls	9.3	-1.6	3.7	6.5	7.2

Annualised volatility	1 year	3 years	5 years	10 years	20 years
ASX 200	11.8	13.3	16.4	14.0	13.7
ASX 300 ex 20	**11.9**	**15.3**	**18.9**	**15.5**	**15.2**
ASX 200 ex 50	12.3	17.0	19.7	16.3	16.0
Smalls	13.3	18.3	20.8	17.2	14.5

Source: S&P and Factset. As at 30 June 2024.

More to look forward to

While the top 20 companies dominate the ASX 200, representing more than 60% of total market capitalisation, they also symbolise yesterday's heroes – with not one stock forecast to achieve 10% revenue growth in FY25. In contrast, 56 companies in the Ex-20 are projected to hit that mark, spanning sectors like technology, new media, and battery minerals.

30.1% of the Ex-20 index is focused on Australia's future growth companies and sectors

Ex-20

PAST					FUTURE
	1.8	Banks	Technology	8.6	
	0.6	Iron Ore[1]	New Media	4.1	
	3.8	Fossil Fuels	Battery Minerals	6.4	
	–	–	Other[2]	11.0	
	6.2	**ASX SECTOR %**		**30.1**	
	60.6			**0.0**	
	34.8	Banks	Technology	0.0	
	20.4	Iron Ore[1]	New Media	0.0	
	5.4	Fossil Fuels	Battery Minerals	0.0	

ASX 20

56
stocks

>10% FY25 revenue growth

0
stock

Source: Yarra Capital Management, Factset, Eikon. As at 30 June 2024.
1. Companies with major earnings from iron ore. **2.** Stocks from sectors other than Technology, New Media and Battery Minerals expected to achieve >10% revenue growth.

The Ex-20 characteristics

An inefficient market

A less efficient market presents greater opportunities for active managers to generate alpa. For example, the top company in the ASX 20, BHP, is covered by 29 analysts, while QBE, ranked 21st, has just 14.

37.2%
of the ASX 200 is Ex-20

Future growth sectors

The Ex-20 index targets high-growth sectors with strong earnings potential. These include base metals like lithium and copper, which comprise 6.4% of the benchmark and are essential inputs for decarbonisation.

Greater diversification

The Ex-20 index offers greater diversification with lower concentration risk, which increases active share opportunities – unlike many ASX 200 funds which passively hold significant positions in major stocks like BHP, CSL and the major banks.

A fertile hunting ground

A wealth of promising companies with runs already on the board can be found outside the top 20. They could have a proven business model that is rapidly growing market share, be creating or entering new markets, or expanding overseas.

Source: Yarra Capital Management, Goldman Sachs. As at 30 June. As at 30 June 2024.

Three of our picks

CAR Group

Formerly Carsales, CAR Group has seen 14% compound annual growth rate for the past few years. It is compelling due to its strong runway to lift yields across key regions and products, is well-positioned to benefit from car dealerships, and has excellent product innovation.

The Lottery Corporation

Australia's primary lottery operator has cash generative assets underpinned by long-dated licenses in a highly defensive segment. The business provides an attractive blend of high single-digit EPS growth and yield, benefiting from inelastic demand, margin expansion from digital lottery adoption, and optionality over pricing and game innovation.

APA Group

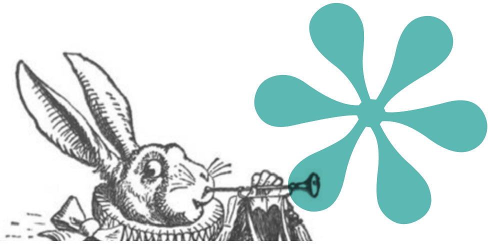
APA has seen its outlook improve materially with the importance of gas as a transition fuel now widely accepted. It is set to be an active participant in the energy evolution via the build-out of electricity transmission infrastructure and decarbonisation of major mine sites in the Pilbara.

The future lies beyond the top 20

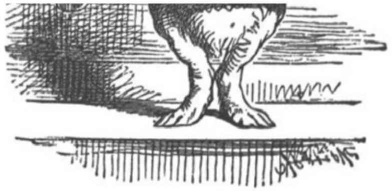
While the Australian equity market may be anchored to banks and iron ore, you don't need to be weighed down by sectors that have passed their peak.

Areas of the market that are less researched (and consequently more inefficient), with strong business models and pricing power are more likely to yield outsized returns.

The Ex-20 provides a way around sluggish growth, offering superior returns and lower risk than small caps, while reducing the systemic risks of over-concentration in specific sectors like banking and iron ore.



[Lastly, make sure you pick a manager who can capitalise on this opportunity through well-researched and insightful active positions.]



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