Ellerston Capital

Ellerston Australian Market Neutral Fund

PERFORMANCE REPORT October 2017

Fund performance^ (Net)

Net	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
2017	0.54%	-0.98%	0.47%	-0.01%	-0.57%	1.64%	-0.40%	0.87%	0.12%	1.09%			2.77%
2016	-0.97%	-1.03%	0.80%	0.10%	1.34%	0.55%	0.71%	1.93%	0.73%	-0.53%	0.29%	0.02%	3.96%
2015	-0.15%	1.09%	1.41%	1.04%	-0.11%	1.29%	0.71%	1.11%	0.88%	0.59%	1.37%	1.09%	10.81%
2014	2.50%	0.33%	0.93%	-0.47%	2.31%	3.60%	1.24%	2.42%	3.16%	-0.82%	1.53%	-0.95%	16.82%
2013						0.48%	1.12%	1.74%	1.38%	2.87%	-0.34%	2.54%	10.18%

^ The net return figure is calculated after fees & expenses. The gross return is calculated before fees & expenses. Past performance is not a reliable indication of future performance. The benchmark is the RBA Cash Rate. The Fund commenced on 3 June 2013.

Return	Net	BM	Alpha	Gross	Portfolio Metrics	
1 Month	1.09%	0.13%	0.96%	1.44%	Positive months	77%
3 Months	2.08%	0.37%	1.71%	2.73%	No. Relative Value positions	100
6 Months	2.76%	0.75%	2.01%	3.80%	No. Special Situations	32
1 Year	3.09%	1.50%	1.59%	4.84%	Net Equity Exposure	+23.8%
2 Years p.a	4.64%	1.66%	2.98%	6.76%	Gross Portfolio Exposure	161.8%
3 Years p.a	5.99%	1.84%	4.15%	8.45%	Beta Adjusted	+4.8%
Since inception p.a	10.01%	2.06%	7.95%	13.45%	Correlation Coefficient (vs ASX 200 Accum)	-10.10%
					Net Sharpe Ratio (RFR = RBA Cash)	2.12

Performance

The Fund returned +1.1% during October, comfortably exceeding the benchmark return of +0.1% in the period. An unusually high number of portfolio transitions seemed to be active in the market, leading to a welcome increase in the return dispersion between stocks within the same industry.

Net exposure of the Fund was +23.8% with a beta-adjusted net of +4.8%. The increase in dispersion led to an increase in gross exposure, which closed the month at 161.8%.

It was no coincidence that 4 of our top 5 pairs in the month featured stocks that have exposure to the improving West Australian (WA) property market. In particular, pairs that featured long positions in Peet (+19.7%), Centuria Capital (+7.1%) and GDI Property (+5.7%) all added value during a period in which the Real Estate sector returned +1.3%.

There are now tangible signs of recovery in the Perth CBD, with 4 successive quarters of positive net absorption in office space, following 26 consecutive quarters of net supply. Importantly, sub-lease availability has reduced, with 24,000 sqm of space being withdrawn from the market in the last 6 months. With over $100 billion of major resource projects under construction or committed and commodity prices generally trending higher, we think the property market has bottomed and continue to favour REITs that have WA exposure.

A raid on the register of Centuria by PE-backed e-Shang Redwood (ESR) also helped buoy the share price, despite the market confused by ESR's strategy of buying into a fund manager. ESR purchased 14.9% of Centuria in mid-October, following their purchase of 19.9% of Propertylink (+7.5%) earlier in the month. We have maintained long positions in Centuria as part of two pairs, hedged with Abacus Property (+0.5%) and Mirvac (+5.2%) respectively. We also hold a long position in Propertylink within Special Situations.

For the third time this year, we established a long position in Fletcher Building (-12.0%) following a downgrade to FY18 earnings. Once again, the downgrade came from the Building and Interiors division, mainly driven by cost overruns at the International Convention Centre project. This time the downgrade was delivered with the announcement that a new CEO had been appointed – the external appointment of the former UGL CEO coming as a surprise. Following the downgrade, Fletcher Building now trades on an FY18 EV/EBITDA multiple of just 8.4x – the market seemingly unwilling to back the new CEO at this early stage. The position is hedged with a short in Adelaide Brighton (+6.5%) which now trades at an FY18 EV/EBITDA multiple of 11.9x.

Ingenia Communities (+0.4%) suffered a setback during October, with the Development Application for Avina declined in a unanimous decision by the Sydney West Planning Panel. Although the company reconfirmed its FY19 target of 350+ settlements, the margin on sales will be considerably lower for the absence of the Avina development. The company is now considering its options, with the decision weighing on the (relative) performance of the stock during the period.

We benefited from the continued campaign from active investor Elliott Advisors to get BHP Billiton (+2.9%) to scrap its dual-corporate structure, with the spread narrowing during the month, adding to performance.

Our holding in the Nufarm hybrid (+3.0%) added value in the month, following the company's acquisition of the "Century Portfolio" and subsequent equity capital raise. The Century Portfolio is highly complementary to Nufarm's (+13.4%) existing European portfolio and is heavily biased towards higher gross margin products in fungicides, insecticides and plant growth regulators. The assets consist of established brands, with over 50 crop protection formulations and more than 260 registrations. The company raised $446 million of new equity to fund the acquisition, with the strengthened balance sheet and earnings profile fuelling the hybrid's rally.

The IPO of Johns Lyng Group (+28.0%) proved a success, with the company listing at a 20% premium on the first day of trade before rallying further into the end of month. Our long position in the company was the largest contributor to Special Situations in the month.

An ordinary 1Q18 result from ImpediMed (-7.5%) led to a fall in the share price during October. The poor sales in the quarter were primarily attributed to key customer sites switching from the conventional L-Dex electrodes to the newly approved SOZO platform. With the lymphedema trial near full enrolment and FDA approval for heart failure monitoring imminent, we feel the company is at an inflection point and continue to maintain our long.

Activity

Relative Value – Gross Contribution 1.1%

We continued to added to our shareholding in renewable energy company Infigen Energy (-3.9%), hedging the position with a short in AGL Energy (+8.1%). Following a poor June quarter as a result of low wind conditions, Infigen bounced back in September with generation up 14% year-on-year and revenue up 16%. The company continues to work towards a restructure of their debt which we believe will result in a rerating of the company's shares.

Rio Tinto (+4.4%) announced an off-market buyback of Limited shares that is scheduled to conclude in early November. The buyback is tax-effective for Australian shareholders and the spread between the Plc and Ltd widened as a result of the additional short-term demand in the Australian listing. We capitalised on the widening spread, adding to our existing position.

We took part in sub-underwriting the Dividend Reinvestment Program (DRP) for Retail Food Group (+2.8%), hedging the resultant long with a short in Domino's Pizza (+1.7%). Retail Food Group is a food brand manager and franchiser with a chain of coffee and donut outlets. We were able to secure the shares at $4.40 – a 4.6% discount to the prevailing share price.

A long position was established in IOOF Holdings (-3.5%), hedged with a short in Janus Henderson (+2.4%). IOOF is an independent wealth management company operating with four major divisions: financial advice and distribution, platform, investment management and trustee services. During the month, IOOF announced the acquisition of ANZ's OnePath Pensions and Investments business and four Aligned Dealer Groups for a cash consideration of $975 million. The acquired businesses are very complimentary and align across IFL's existing financial planning and distribution, platform and investment management divisions.

The transaction was funded through a combination of a fully underwritten equity placement, a share purchase plan and debt. The deal makes strategic sense and transforms the company by adding scale to its existing key divisions. IOOF will be propelled to being the second largest advice business by adviser numbers and funds under advice, and the fifth largest platform provider by funds under administration in Australia. Funds under advice increase by 34%, financial adviser numbers increase by 71% and funds under administration will be up by 125%. We believe the transaction positions the group as a significant independent wealth manager in the growing segment of superannuation and wealth management, delivers substantial EPS growth prospects, and the liquidity event even provided an attractive entry point.

Special Situations – Gross Contribution 0.3%

Long positions in both Propertylink and Carindale Property (+1.4%) were established in the month, with both companies firmly in the cross-hairs of corporate suitors. As mentioned previously, Propertylink was the subject of two share raids in October, with over 37% of the register now held between Centuria and ESR. Both suitors have a natural interest in Propertylink, with Centuria managing the well-regarded Centuria Industrial REIT (+2.8%) and ESR know for their investments in Asian logistics assets.

The major shareholder of Carindale, listed retail landlord Scentre Group (+2.3%), continues to creep up the register, with Scentre advising the market in October that they now held almost 57% of the shares on issue.

We reduced our holding in the ANZ Bank Convertible Preference Shares (+0.8%) following a rebound in their price after the sell down in September. We also reduced our exposure to Abano Healthcare (+4.8%), Superloop (+5.9%), Bravura Solutions (+4.3%) and the National Australia Bank Income Securities (+1.4%) during the period.

Sector Allocation

Sector	Long Equity	Short Equity	Net Equity
Banks	0.4%	0.0%	0.4%
Div Financials	0.4%	0.0%	0.4%
Insurance	0.8%	0.0%	0.8%
Regional Banks	0.0%	0.0%	0.0%
REITs	48.8%	-41.4%	7.4%
Financials	50.4%	-41.4%	9.0%
Builders	2.6%	-2.0%	0.6%
Consumer Disc	5.2%	-0.2%	5.0%
Consumer Staples	0.9%	-0.6%	0.4%
Gaming	0.0%	0.0%	0.0%
General Industrials	0.3%	0.0%	0.3%
Health Care	2.9%	0.0%	2.9%
Information Technology	1.5%	0.0%	1.5%
Infrastructure	0.0%	0.0%	0.0%
Materials	1.1%	-1.1%	0.0%
Media	3.3%	-1.1%	2.2%
Telcos	0.0%	0.0%	0.0%
Utilities	3.6%	-2.1%	1.4%
Industrials	22.0%	-7.1%	14.9%
Bulk Metals	16.1%	-15.9%	0.2%
Energy	0.2%	0.0%	0.2%
Gold	0.0%	0.0%	0.0%
Resources	16.3%	-15.9%	0.4%
Hedge	0.0%	-0.4%	-0.4%
Index	0.0%	-0.4%	-0.4%
Total	88.7%	-64.9%	23.8%

Market Commentary

In October, world equity markets recorded strong gains, supported by solid earnings growth and increasing evidence of synchronized global growth. The US economy recorded its fastest six-month stretch of growth in three years; 3% in the third quarter of 2017, following a 3.1% print in the second quarter. US stocks had their best month since February and the dollar strengthened as investors assessed the prospects for the much anticipated tax cuts. The Dow Jones Industrial Average Index ended the month up 4.4%, adding nearly 1,000 points. The broader S&P 500 Index finished October up 2.3%. US markets were also supported by positive company earnings growth, especially in the technology sector. Shares in companies like Amazon, Alphabet and Microsoft reached near record highs. However, it was the global bellwether, Caterpillar's market-beating third quarter earnings that really excited markets. Caterpillar's results showed that not only is US construction booming, but the company was seeing strength across a number of industries and regions, including construction in China, on-shore oil and gas in North America and increased capital investment by mining customers. As a result, Caterpillar materially increased its forward guidance. Further evidence of the continued pick up in the US economy emerged with McDonald's reporting strong restaurant sales in the period.

Despite the US Federal Reserve signaling an increase in official interest rates in September, the modest increase in inflation; 2.2% in September, up from 1.9% in August - has commentators speculating on the timing of the next hike. Additionally, in October, speculation over the new chair of the Federal Reserve continued. On 2 November, President Trump named Jay Powell as the next chair of the Federal Reserve. Mr. Powell is a lawyer and former partner of private equity firm Carlyle and has been serving as a governor on the Federal Reserve since 2012. He is well credentialed and is not expected to deviate from the policy path set out by Janet Yellen, the exiting chair.

In Europe, the European Central Bank extended it quantitative easing program despite economic growth being strong across most regions. However, the ECB said that it was reducing the quantum of its asset purchases to €30 billion a month from €60 billion, effectively scaling back its QE program. The Bundesbank president, who expressed his concern that the European economy was growing more strongly than expected and therefore suggested that further stimulus was unnecessary, attacked the ECB's decision. But with inflation within the ECB's target, Mr. Draghi said that further QE was justified. Markets, helped by positive earnings reported by companies including food group Danone, reacted positively to this delicate dual balancing act of managing growth and inflation. European equity markets were stronger in the month, with the Euro Stoxx 50 index up 2.3%, while Germany and France both rallied 3.1%. In contrast, the Spanish market was up only about 1% as that country's political unrest - Catalonia wanting independence from Madrid's control - took its toll on investor confidence.

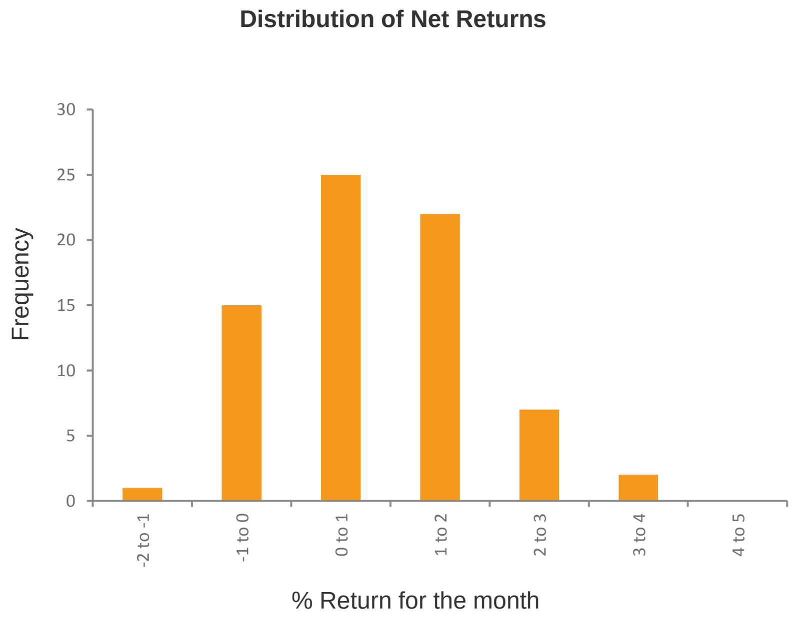
The UK economy expanded faster than expected in the third quarter of 2017 with GDP growing 0.4%. Inflation over the last 12 months reached 3%. The governor of the Bank of England (when giving evidence before a Treasury committee) said that the fall in the pound since Brexit meant that inflation was likely to rise over 3% in the near future. The BOE had previously voiced its concern over inflation and on 2 November raised interest rates for the first time in a decade by a quarter of a percentage point to 0.50%, signaling the start of a gradual increase in borrowing costs. The UK equity market returned +1.8% in the period.

Most major Asian exchanges recorded very strong rises in October, led by the Nikkei which rose by 8.1%, the Indian exchange up 6.4%, and the Hang Seng up almost 3% while the Chinese market fell by 3.1%.

In Australia, the government was in chaos after the High Court ruled that the Deputy Prime Minister, Barnaby Joyce, was ineligible to sit in parliament because he was a dual citizen of New Zealand when elected. The ruling means that the government no longer has a one-seat majority on the floor of the lower house and forces Barnaby Joyce to contest his seat of New England again in a bi-election. The government now faces weeks of uncertainty and will struggle to pass any legislation, including any attempts to pass company tax cuts. However, the S&P/ASX 200 Accumulation Index shrugged off the political imbroglio to close up 4.0%. After lagging the rest of the world over the past six months, the Australian market finally began to respond to the increased evidence of a global growth pick up. With commodity prices holding up, analysts upgraded earnings for the resources sector, adding to the earnings growth for the market as a whole for FY18 (after a lack of earnings upgrades for FY18 during the reporting season). Stronger global growth, sustained higher commodity prices and earnings upgrades have combined to lift confidence about the Australian economy. Australian consumer sentiment has also picked up despite patchy data for retail sales and wages. Taken together, this has seen many investors return to the market.

Contribution

Relative Value Gross Contribution	1.1%	Special Situations Gross Contribution	0.3%
Positive		**Positive**	
PEET - SHOPPING CENTRES AUSTRALASIA	0.31%	JOHNS LYNG GROUP PTY LTD	0.13%
CHARTER HALL RETAIL REIT - PEET	0.23%	NUFARM FINANCE NOTE	0.10%
BHP BILLITON - BHP BILLITON PLC	0.21%	CLOVER CORP	0.05%
CROMWELL PROPERTY GROUP - PEET	0.18%	MURRAY RIVER ORGANICS PTY LTD	0.03%
ABACUS PROPERTY GROUP - CENTURIA CAPITAL	0.16%	IOOF HOLDINGS LTD	0.03%
Negative		**Negative**	
ADELAIDE BRIGHTON - FLETCHER BUILDING	-0.14%	IMPEDIMED	-0.11%
AGL ENERGY LTD - INFIGEN ENERGY	-0.14%	YOWIE GROUP	-0.10%
INVESTA OFFICE FUND - MIRVAC GROUP	-0.11%	TURNERS AUTOMOTIVE GROUP LTD	-0.05%
INGENIA COMMUNITIES GROUP - MIRVAC GROUP	-0.09%	S&P/ASX 200 INDEX PUT OPTIONS	-0.05%
GROWTHPOINT PROPERTIES - INGENIA COMMUNITIES GROUP	-0.07%	PRO-PAC PACKAGING LTD	-0.01%



TOP RELATIVE VALUE POSITIONS

- BHP BILLITON - BHP BILLITON PLC
- RIO TINTO - RIO TINTO PLC
- AGL ENERGY LTD - INFIGEN ENERGY
- AUSTRALIAN UNITY INVESTMENT REAL ESTATE - GPT GROUP
- INVESTA OFFICE FUND - MIRVAC GROUP
- INGENIA COMMUNITIES GROUP - MIRVAC GROUP
- AVEO GROUP - MIRVAC GROUP
- PEET - SHOPPING CENTRES AUSTRALASIA
- GOODMAN GROUP - INGENIA COMMUNITIES GROUP
- ELANOR RETAIL PROPERTY FUND - SHOPPING CENTRES AUSTRALASIA

TOP SPECIAL SITUATION POSITIONS

- NUFARM FINANCE NOTE
- AUSTRALIA AND NEW ZEALAND BANKING
- NATIONAL AUSTRALIA BANK NOTE
- IMPEDIMED
- HANSEN TECHNOLOGIES LTD
- PROPERTYLINK GROUP
- ONEVIEW HEALTHCARE
- TURNERS AUTOMOTIVE GROUP LTD
- PRO-PAC PACKAGING LTD
- JOHNS LYNG GROUP PTY LTD

Key Information

Fund Inception Date: 3 June 2013

Liquidity: Daily

Management Fee: 1.20%

Performance Fee: 20% of outperformance

Buy/Sell Spread: 0.25%

Application price: $1.1665

Redemption price: $1.1607

Market Neutral Fund AUM: $653.74M

Australian Equity Team AUM: $3.09bn

Firm AUM: $5.2bn

Key Service Providers

- Registry: Link Market Services Limited
- Auditor: Ernst & Young
- Prime Broker & Derivative Counterparty: Morgan Stanley Intl & Co PLC
- Administrator: State Street Australia Limited

Material Matters

During the month there were no material changes to the Fund in terms of its risk profile, investment strategy or changes to investment staff which would impact this strategy. There have been no changes to the key service providers described above.

Closure of the Market Neutral Fund

Please note that the Ellerston Australian Market Neutral Fund was closed on the 31st October 2016. From 1 November, the Fund ceased to accept new or additional applications. Redemptions from the Fund will be processed as normal.

Further Information

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