ELLERSTON CAPITAL

Ellerston Overlay ASF

PERFORMANCE REPORT August 2017

The investment objective of the Ellerston Overlay ASF (Fund) is to provide investors with a return that outperforms the S&P/ASX200 Accumulation over time. The Fund aims to achieve this by investing in a concentrated portfolio comprising of no more than 30 Australian listed securities and where possible, enhancing income through the use of Derivatives and shorter term trading strategies. The Fund aims to be invested with a minimum of 90% in physical securities at all times and must maintain a net exposure of 50% or greater. At least 75% of the Fund will be aligned to the portfolio of the Ellerston Australian Share Fund (EASF).

Ellerston Overlay ASF Performance

	Gross	Benchmark	Excess	Net
1 Month	0.86%	0.71%	0.15%	0.78%
3 Months	(2.55%)	0.88%	(3.43%)	(2.79%)
Rolling 12 Months	5.11%	9.80%	(4.69%)	4.34%
2 Years (p.a.)	9.81%	9.55%	0.26%	8.92%
3 Years (p.a.)	6.65%	5.14%	1.51%	5.69%
5 Years (p.a.)	11.91%	10.57%	1.34%	10.77%
Since Inception (p.a.) 4 Jan 2012	11.76%	10.91%	0.85%	10.60%
Since Inception (CUM)	87.73%	79.86%	7.87%	77.02%

Returns are calculated using the Fund's redemption price and are net of fees and expenses. Returns are also calculated on the basis that distributions are reinvested.
Returns of the Fund may include audited and un-audited results.
The benchmark is the S&P/ASX200 Accumulation Index. Past performance is not a reliable indicator of future performance.
Since Inception is 4 January 2012.

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Market Commentary

The equity markets kicked off on a reasonably positive note in August, with key indices such as the S&P500 hitting new record highs, at least until investors quickly pressed the 'risk-off' button as geopolitical tensions in the Korean peninsula escalated. US Equities finished August higher, with the Dow Jones (+0.65%) and S&P 500 (+0.3%) notching five-month winning streaks, and the Nasdaq recording its 9th positive month of the last 10. US/North Korean tensions further ratcheted up, with President Trump warning North Korea about facing "fire and fury" if the regime of Kim Jong-un continued threatening the US. North Korea responded by saying it was "carefully examining" its strategy of a missile strike on the island of Guam. Towards month end, North Korea tested a missile which travelled over Japan's northernmost island, Hokkaido. President Trump's continuing political battles and Hurricane Harvey in the Gulf didn't help sentiment.

Against this backdrop, in Europe, the Euro Stoxx 50 Index (-0.7%) floundered while Asian equities were mixed through August. The Nikkei 225 fell 1.4%, whilst Singapore and Korean markets both fell 1.6% respectively. Hong Kong's Hang Seng was the best performer, finishing 2.4% higher, despite the arrival of Tropical Cyclone Hato.

Emerging markets also outperformed (MSCI World Emerging Markets index +2.1%), aided by rising commodity prices.

The main feature in commodity markets during the month was the sharp rally in base metal prices, with aluminium, copper, nickel and zinc hitting multi-year highs on optimism around synchronized global growth, ongoing supply constraints and a weakening U.S. Dollar. Not surprisingly, the gold price rallied in August to close at a 9 month high of US$ 1,321/oz, as US/North Korean tensions persisted and investors rushed into the yellow metal as a store of value/safe haven.

Economic data was generally supportive, as the OECD noted that all 45 countries it tracks were poised to grow this year, the first period of synchronised growth since 2007. In the US, employment remained strong, as non-farm payrolls for July rose a stronger-than-expected 209,000 (consensus 180k) and the unemployment rate fell to 4.3%. The CPI for July also rose a weaker-than-expected 0.1%m/m (vs. consensus +0.2%). Real GDP for Q2 was revised up to a better-than-expected 3.0%q/q annualised (consensus: 2.7%) from a previously estimated 2.6% print.

In Europe, activity indicators were also strong, with the flash Eurozone manufacturing PMI for August rising to a stronger-than-expected 57.4 (consensus: 56.4).

The Australian equity market absorbed an incredibly volatile reporting season, bouncing off an index low of circa 5,680 five times through the month, but also failing to break the 5,800 point threshold on the upside. **The S&P/ASX200 Accumulation Index finished +0.71%**, but with significant variation between sector returns. The positive August total return was due entirely to the +80bps dividend contribution, with the ASX200 price index falling 0.1% in the period.

Energy (+5.7%), Consumer Staples (+5.3%), Industrials (+4.6%), Materials (+4.6%) and Utilities (+3.2%) were the best performing sectors. Materials added the most value in August, largely driven through the Miners (BHP Billiton, Rio Tinto, Newcrest Mining), with support from the Energy (+23 bps), Consumer Staples (+38 bps) and Industrial (+33 bps) sectors. Financials (-82 bps) provided the largest drag on performance, with Banks (-72 bps) and Insurance (-16 bps) accounting for most of the sector losses.

The domestic reporting season was primarily one of missed expectations. The ratio of misses to beats stood at ~1.3x, with the average EPS miss being penalized by -3.8% on results day. At the top line, 16% of companies beat on revenue, while 22% missed. Most importantly, of the ASX 200 stocks that reported, ~55% provided guidance, of which 44% triggered FY18e EPS downgrades, versus only 27% of stocks that received an upgrade.

Company Specific News

The Misses

Vocus (VOC -33.8%)
In early June, KKR made an indicative offer for Vocus at $3.50. After a month of consultation, KKR was granted access to conduct due diligence which also attracted Affinity Equity Partners to the table. However in what is becoming an all too common event, a deal failed to consummate, leaving shareholders with more questions than answers.

Mayne Pharma (MYX -30.2%)
MYX collapsed after missing guidance that was issued just a fortnight before announcing its results. The Teva US generics business, which was acquired in July 2016, is facing material pricing pressure post recent tenders by the largest buyers in the industry. The 2018 year will be another challenging one and the market cut earnings estimates by 10-12%.

Isentia Group (ISD -20.7%)
Perennial downgrade offender Isentia issued yet another profit warning, with a revised EBITDA of $41.5m compared to previous guidance of circa $44m. The downgrade was driven by bad debts in Asia, adverse FX impacts and losses from Content Marketing. In addition, the company fully wrote-down the value of King Content.

Domino's Pizza (DMP -18.2.%)
Domino's long-run of managing and beating market expectations came to a spectacular halt in FY17, missing its 30% growth target by 2% and consensus by 4%. Issues in its French operations caused most of the shortfall. Compounding the impact, the company guided to 'only' 20% growth in FY18 vs. consensus expectations of 30%. The once highly rated name was savaged, finishing down 19% on the day.

Trade Me (TME -17.6%)
TME consolidated on a good first half to deliver FY17 adjusted NPAT up 12% at NZ$93m, with pre-associate EBITDA up 9%. Divisional highlights were Jobs (revenue +25%) and Marketplace (+7%), although GMS slowed considerably in 2H. The negative surprise of the day was the outlook comments, with TME announcing it will invest in a range of platform-centric initiatives, with costs expected to outgrow revenue in FY18.

Bluescope Steel (BSL -17.5%)
Bluescope reminded the market that it is a cyclical and operationally leveraged company, with guidance for 1H18 coming in some 20% below the market's expectations. An uncertain US steel market, continued dumping of product in Australia and higher domestic energy costs all contributed to the soft outlook.

Japara Healthcare (JHC -17.2%)
Whilst the headline number was in line with guidance, JHC reported a disappointing underlying FY17 result, with the reported EBITDA of $60.2m being boosted by circa $5m of profits on property sales treated above the line. Given the impacts of funding changes (freeze to ACFI indexation and reduced complex patient re-imbursement), the company has guided to flat earnings in FY18.

iSelect (ISU -17.3%)
iSelect reported EBIT at the low end of guidance at $22.5m vs consensus at $24m, blaming weaker revenue from the energy and telco sectors which adversely impacted the company.

Healthscope (HSO -16.4%)
One of our core stocks, HSO delivered an FY17 result that was broadly in line with market expectations. However, the share price fell sharply due to the surprisingly weak FY18 guidance, where the company stated that expected EBITDA from the hospital division was expected to be flat. The hospital division has been impacted by two specific factors that will impact FY18, the first is a much slower ramp up at the new Holmesglen and Frankston facilities in Victoria and the second being higher wages inflation in that state. The net result was the market downgrading earnings for the company by circa 10% in FY18.

Chorus (CNU -12.3%)
Chorus reported EBITDA of NZ$652m which was in-line with expectations, however higher depreciation charges delivered an NPAT figure of just NZ$113m, which was 10% below street expectations. That, combined with FY18 guidance that was circa 5% below consensus, precipitated the sharp fall.

Sigma Health (SIG -10.9%)
Early in the month, Sigma downgraded FY18 earnings guidance due to sales weakness, primarily in the consumer products sold to pharmacy customers. The company now expects EBIT to be $90m in FY18, down 11% on the $101m reported in FY17.

QBE Insurance (QBE -10.1%) It's deja vu all over again. QBE delivered a result in-line with lowered guidance, but the quality of the result was poor. Higher reserve releases than previously guided flattered the numbers. However, the company downgraded the outlook again with a higher (worse) combined ratio now expected. The emerging market book also suffered unexpected losses, prior year reserve releases were expected to be lower, and the US crop book was worse than expectations. Forward earnings were downgraded between 6% and 12%. The company commenced its share buy-back, but this had little impact as management's credibility is on the line and has been significantly tarnished.

James Hardie (JHX -7.7%)
JHX reported 1Q18 NPAT of US$61.1m, down 8.4% on pcp. The weaker than expected result was driven by poor plant performance and much higher-than-expected manufacturing costs in North America, where EBIT fell to US$79.8m, down 15.6% on pcp. This was the fourth earnings miss in a row and is testing investor patience. The outlook commentary was also disappointing, with management describing the 2Q forward order file as "soft".

Sirtex (SRX -6.8%)
SRX delivered a very messy FY17 result that at an underlying level, missed the EBITDA guidance only provided in late June. At a reported level, the company delivered a loss of $26.3m, driven by a $90m charge relating to R&D write-offs, restructuring charges and impairments. Post the result, consensus earnings expectations for FY18 were downgraded by over 10%.

Telstra (TLS -6.6%)
Management at Telstra spent the last 9 months working on a capital management plan that would endure through the tumultuous NBN migration. The outcome was underwhelming, with the projected annual dividend cut to 22c supported by the securitisation of the NBN compensation payments. That plan was thrown into turmoil at the end of the month as NBN Co. rejected Telstra's securitisation plan.

Suncorp Group (SUN -6.0%)
SUN's result disappointed and contained an unexpected additional $100 million after- tax spend on its "Marketplace" strategy in FY18. Not only is the market sceptical on the strategy, it was surprised by the additional spending earmarked for "knock-out" applications, brand refresh and the like. General insurance margin targets also appeared more difficult to achieve. The end result was material earnings downgrades (up to double digits) to earnings looking out.

IAG Group (IAG -3.9%)
IAG's results were also weaker in the 2H relative to expectations, with underlying insurance margins down to 11.2%, off 140 basis points on 1H. The company attributed the weaker 2H result to adverse commercial loss experience, claims inflation in motor insurance and higher allowance for natural perils in the year. IAG is a high quality business that was trading on a high multiple and the miss was accordingly marked down by the market.

Magellan (MFG -4.6%): MFG was impacted by results slightly below expectations and higher ongoing employee and marketing costs and costs relating to the new listed vehicle (Magellan Global Trust) which is part of the company's continued push into the retail market. The company also announced its intention to close the global equities strategies to institutional flows. A premium stock on a premium multiple clearly suffering from some growth adjustments.

Ramsey Healthcare (RHC -3.2%)
RHC reported an FY17 result up 13%, which was in line with guidance. The result however, was weak at the operational line, with the Australian hospital division lighter than expected and only a lower tax rate getting it across the line. Outlook guidance was for 8-10% earnings growth in FY18, which is below the historic levels of low teens. A combination of declining earnings from France and the UK (lower tariffs / re-imbursements) and currency headwinds resulted in circa 3-5% earnings downgrades.

Resmed (RMD -0.1%)
RMD reported its second poor quarter in succession. The disappointment was driven by a combination of lower gross margins and softer mask sales growth (especially in the USA). Analysts reduced expectations for FY18 by circa 5% post the results

The Hits

Blackmores (BKL +27.7%)
Whilst BKL reported an FY17 result of $59m (down 41% on pcp), the Q4 result was actually the strongest in the last 12 months. Q4 sales grew by 6%, cycling a strong pcp and excluding one-off provisioning, underlying EBIT fell by 7.5% in the quarter. This suggests that the business has started to find a base after a very challenging FY17. The share price rallied on the back of the result, as the market was fearing a continuation of the weak past 9 months performance.

Mineral Resources (MIN +23.5%)
Whilst the resources sector in general enjoyed a positive reporting season, the top gong went to MIN. Not only did it deliver strong FY17 results, but an upgrade to its total resource and positive FY18 EBITDA guidance of a minimum of $500m in EBITDA easily surpassed expectations and helped buoy the stock.

A2 Milk (A2M +21.7%)
A2 Milk delivered an outstanding result with NPAT of $90.6m, up 198% on pcp and circa 5% above market expectations. The key feature of the result was very strong infant formula sales, which drove a significant increase in gross margins that dropped through to the bottom line. Given a strong net cash balance sheet, the company also announced a modest $40m buyback.

Asaleo Care (AHY +20.8%)
Asaleo reported 1H17 EBITDA of $60.9 million, up 4%, with the result characterized by modest sales growth, but lower operating costs. The company maintained its previous earnings guidance despite facing higher electricity prices, which have been partially offset by lower input costs (pulp) and a higher $A.

Treasury Wine Estates (TWE +20.0%)
TWE earnings continued to surge ahead driven by cost savings and strong demand for its premium red wines in China. A surprise buyback of $300m and an aspirational target to grow EBIT margins to 25% over time drove the stock to new record high levels.

Whitehaven Coal (WHC +17.9%)
WHC benefitted from higher coal prices and is now in a strong financial position, with operating cashflow in 2H17 jumping to $370m. With coal prices maintaining a stunning run throughout August and a growing expectation for WHC to payout all ongoing excess cash, patient shareholders are finally being well rewarded.

Orora (ORA +12.3%)
Orora reported an underlying net profit of $186.2m in FY17, up 10% on pcp and ahead of the market forecast of $180m. Australasian earnings of $214m were up 7% on pcp while North American earnings of $117.5m were up 19% on pcp. The company has guided to underlying earnings growth in FY18 in constant currency terms, subject to global economic conditions.

Medibank (MPL +11.8%)
MPL delivered an operating result of $497m which was modestly above previous guidance of $490m. The features of the result were stronger gross margins, which were partially offset by higher expenses. Whilst customer numbers continued to decline, the rate of decline is slowing. Driven by strong leadership and excellent management execution, the result was the clear standout in comparison to the rest of the insurance sector which generally disappointed.

Flight Centre (FLT +11.2%)
Flight Centre delivered at the top end of its guidance range. Whilst that impressed, it was the company's confidence to give long-term earnings guidance, to achieve 7% TTV growth and deliver 2% net margins in the next 3-5 years that pleased the market.

Costa Group (CGC +10.9%)
Costa Group delivered a strong full year result of $115m, up 29% on pcp and 10% above company guidance. FY17 was a great year with all divisions performing strongly. The standouts were Avocados and Berries which both grew sales by over 25%. Company guidance for FY18 is for 10% growth.

Cochlear (COH +9.4%)
Cochlear reported a strong full year result with underlying profit up 18%, broadly in line with expectations. The highlight of the result was unit growth (ex-China) of 14%, with Cochlear winning share in developed markets on the back of the recently launched Kanso processor. FY18 guidance of $240-250m was broadly in line with market numbers.

Caltex (CTX +7.2%)
Caltex reported numbers at the top-end of guidance driven by strong growth in Supply & Marketing and Refining. A $60m cost out plan, which along with recent acquisitions will go a long way to offset the impact from the loss of the Woolworths supply contract and support earnings in FY18 and beyond.

In the wash up, 2018 Industrial earnings growth has been slashed from +11.1% to +6.3%, while 2018 earnings for Resources have been upgraded from -15.9% to +6.0%. Banks (~2.5%) saw 2018 growth estimates stay relatively unchanged.

Resources exhibited leadership, though Banks and Telcos were a drag on market performance: Resources outperformed the broader market in August by 4.8%, with strong returns across both Energy and Metals & Mining, neutralising the losses incurred by the Banks and Telco sectors. The performance of the Oil & Gas sector was solid on better-than-expected results, with a combination of stronger cash flow, a beat on costs and debt reduction (OSH, STO) helping to drive earnings upgrades.

Materials also fared well, largely driven by upgraded guidance on top of exceptionally strong cash flow generation. This included FMG, ILU, NCM, MIN, MGX, OZL and S32. Both BHP and RIO were also major positive contributors and outperformed over the month. While BHP FY17 reported earnings and dividends were slightly disappointing, the decision to exit US Onshore was taken as a positive. Another highlight during the month was the broad strength in the capex sensitive stocks, namely **CIM, DOW, MND & WOR** which have benefited from a deepening pipeline of projects and/or a stabilization in commodity sensitive spending. The Gaming sector was also strong in the month following reasonable results (**SGR** +4.9%, **ALL** +4.5%).

Significant drags over the reporting season came from Telco's (-7.6%) and Financials (-2.9% and specifically Insurance -4.9% and Banks -3.4%). The Consumer Discretionary sector also fared poorly (-2.4%, led down by specialty Retail -4.9% and Media -4.2%).

The **Financials** were hit by a string of weaker than expected results from the heavyweight insurers (**IAG** -3.9%, **QBE** -10.1% and **SUN** -6.0%) on the back of weaker margins, as well as weakness in banks (excluding **BEN** +7.5%), led down by **CBA (-6.9%).** Bank trading updates and CBA's result showed positive margin trends and benign asset quality, although increased political and regulatory scrutiny had the Banks down -3.2% relative to the ASX 200.

The sticker shock story in the Australian market broke on 3rd August, when AUSTRAC (Australia's financial intelligence agency with regulatory responsibility for anti-money laundering and counter-terrorism financing) initiated court proceedings against **Commonwealth Bank of Australia**, alleging it failed to act on suspected Money Laundering activities via its Intelligent Deposit Machines (smart ATMs). It is alleged **CBA** breached AML requirements on 53,700 occasions since 2012 by not reporting cash deposits above the $10,000 threshold. It is also alleged 1,640 of these breaches were connected to money laundering syndicates.

CBA shares fell 3.9% on the day of the announcement and subsequently announced that its Managing Director and Chief Executive Officer, Ian Narev, will retire by the end of the 2018 financial year. **A**n announcement was made by APRA that an inquiry pertaining to CBA'S governance, culture and accountability practices would be undertaken.

The Telecommunications sector continued to underperform, having done so in 7 out of the 8 months CYTD and though VOC was the worst performing company in the sector, a cut to TLS dividend to 22c from Consensus of 30c announced at results had TLS (-7.4%) below the ASX 200 for the month. On top of **TLS's** dividend cut (surprise surprise), the telco sector was also weighed down by substantial declines from both **CNU** (-12.3%) and **VOC** (-33.8%) as suitors walked away.

At an individual company level, BHP (+33 bps) was the largest single name stock contributor to the ASX200 in August, followed by WES (+23 bps), NCM (+13 bps) and TWE (+12 bps) with RIO (+11 bps) rounding out the top five contributors. CBA had the largest negative impact at stock level, (-65 bps) followed by TLS (-22 bps) and WBC (-13 bps) which did not escape unscathed.

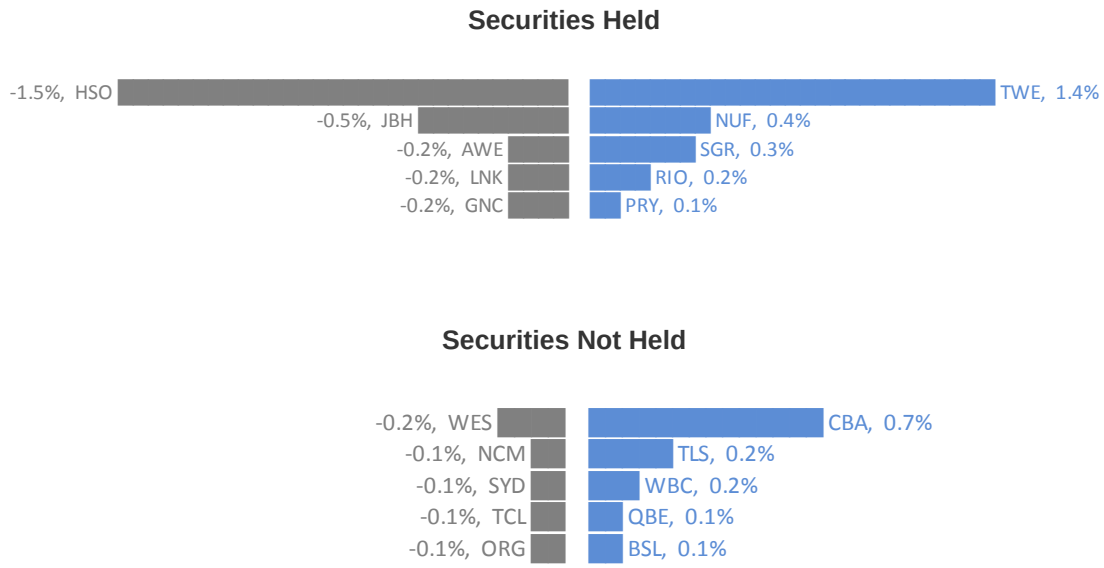
The best performing ASX100 stocks during the month included **Treasury Wine Estates** (+20.0%), **Northern Star Resources** (+19.8%) and **Alumina** (+14.4%). Conversely, the worst performers included **Vocus Group** (-33.8%), **Domino's Pizza Enterprises** (-18.2%) and **Bluescope Steel** (-17.5%).

For the month of August, the S&P/ASX Small Ords rose +2.71%, with the Small Industrials rallying +1.69%, as the Small Resource index jumped +7.09%.

In Small Caps, **A2M**, **MIN, WHC, BKL**, and **WOR** added the most points to the Small Ordinaries, and **MYX**, **TME**, **AHG**, **API, SIG** and **NVT** were the biggest detractors.

Performance

In a challenging environment where the dispersion of returns were astonishing, the Fund's return of +0.86% slightly outperforming the benchmark return of +0.71%.



The main contributors to this month's performance were overweight positions in Treasury Wines **(TWE + 20.0%)**, Nufarm Limited **(NUF +5.3%)** and Star Entertainment **(SGR +4.9%)**, while having a zero weight in Commonwealth bank **(CBA -6.9%)** had a positive impact on performance. The main detractors were overweights in Healthscope **(HSO -16.4%)** and JB Hi-Fi **(JBH -9.4%)**.

Activity

In a relatively subdued month (with all hands focused on the reporting season), we continued to strengthen the Fund's newly established position in **BHP** and following a solid earnings beat by **Janus Henderson** and commensurate share price rally, we exited our position.

Strategy & Outlook

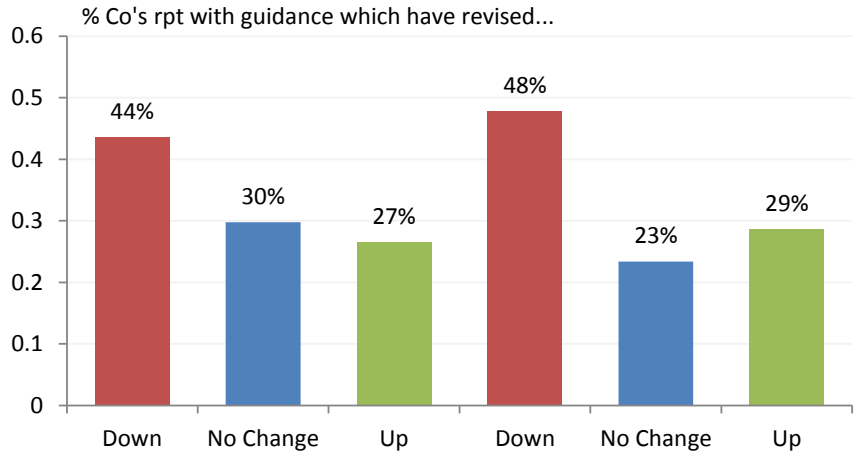
The FY17 domestic result season unfolded into a fairly sobering affair. There were more misses than beats (1.3x), more FY18e downgrades than upgrades (~2:1) and a plethora of outsized negative share price reactions. **Aggregate consensus EPS growth for FY18 is now forecast to decelerate to circa 6%, with no meaningful growth pick up expected in outer years.**

Having navigated another set of results, consensus earnings expectations across the forecast years have been downgraded, with consensus aggregate FY17 EPS growth falling from +12.6% to 12.0% (m/m), whilst FY18 EPS growth stands at ~+6.0%. More importantly, of the 170 companies within the ASX 200 universe reporting results, 55% provided guidance, of which 44% have triggered FY18 EPS downgrades, whilst only 27% of stocks received upgrades. Upgrades also led to these companies outperforming on the day of the result (by +2.2% relative) and post-result (a further +3.8% on average). On the flipside, stocks where consensus downgraded EPS, resulted in an average relative return of -2.4% on the day, and then subsequently continued to underperform the ASX 200 by -3.8% by month end.

Regional Domestic Earnings Underperformance: Putting Australian results in a global context, **the ASX weighted miss of -0.7% compares with an +8.3% earning beat for the Topix, +6.3% for MSCI Europe and +5.4% across the US**. China and HK companies reported the strongest net income beat in APxJ/EM, with Taiwan, Singapore and Australia missing. Australia's lack of earnings gusto has no doubt been a key contributor to its bottom-quartile regional

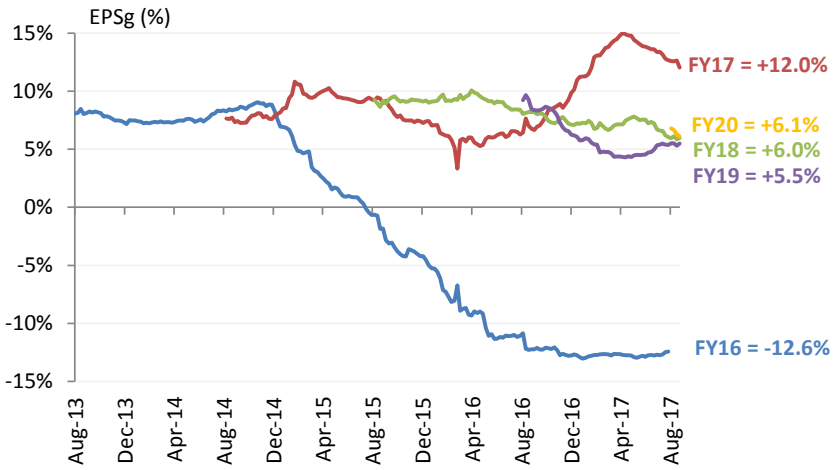
performance this CYTD, with weak income and tighter personal credit conditions making the domestic revenue environment difficult. As the all-important Christmas season looms and factoring in higher energy costs, the market is facing a ~1.4% squeeze on ex-food retail sales, equating to about 8% less 'Christmas cheer'.

Of the 170 companies within the ASX 200 that reported results, with 55% providing guidance, of which 44% have seen FY18 consensus EPS downgraded, with 27% upgrades for a down/upgrades ratio of 1.6x in FY18 and 1.7x in FY19



Source: Factset, IBES, Morgan Stanley Research. Note: Down/Up is where consensus EPS has been revised by +/-1%

Consensus aggregate for FY18 is holding at +6.0%, still to incorporate the final wash-up of results release, though we are expecting this to fall to circa +5.0%



Source: RIMES, IBES Consensus Aggregate, Morgan Stanley Research. IBES Consensus Aggregate as at 24/08/2017

The main focus for investors in the coming months will be rising political tensions between North Korea and the US after North Korea successfully tested a hydrogen bomb on the 3rd of September with what they called "unprecedentedly big power". Just hours after the US Geological Survey recorded a 6.3 magnitude earthquake near North Korea's nuclear test site in Punggye (in the county's northeast region), Pyongyang's official Korean Central News Agency (KCNA) announced that North Korea had successfully tested a massive hydrogen bomb that can be delivered by intercontinental ballistic missile (ICBM). The international community confirmed that this was North Korea's sixth nuclear test, with the number of North Korean provocations this year having already exceeded last year's figure. This test is the first major nuclear test since Trump came into power, with South Korea agencies reporting that it was 6 times stronger than the blast from September last year.

Trump did what any self-respecting leader of the modern world would do … resorted to Twitter of course … threatening to not only increase sanctions on North Korea, but also on any country trading with them as well, which would clearly put China front and centre. Trump tweeted … ***"The United States is considering, in addition to other options, stopping all trade with any country doing business with North Korea" … "its words and actions continue to be very hostile and dangerous to the United States".***

China immediately strongly condemned the test, saying "we strongly urge North Korea to face the strong will of denuclearisation from the international community, earnestly abide by the relevant resolutions of the UN Security Council, stop taking mistaken actions which worsen the situation and are also not in line with its own interests, and effectively return to the track of solving the problem through dialogue". Japan's Chief Cabinet Secretary Yoshihide Suga also said in Tokyo that the North Korean threat has now reached a new level and said that China and Russia restricting their oil product exports to Kim Jong-un's regime is an option to consider.

Pyongyang's latest provocation clearly raises the risk of tensions escalating. Room for diplomatic engagement could be rather limited and we acknowledge that the risks of a US military intervention or miscalculations by Pyongyang are rising. We will be closely monitoring geopolitical developments, especially the US and Chinese responses and any further provocation by North Korea, but it's difficult to formulate a strategy against this backdrop.

While no one desires the outbreak of war, we have learned from history that world leaders (including dictators) always think that they have a chance of winning and justifying outcomes, if in fact war becomes inevitable. Arguments that 'rational dictatorships' such as North Korea would avoid undermining their own existence by embarking on a course that could destroy their country have never prevented people in the past from going down that road (such as during the lead up to WW2) and then losing control over events. Extreme outcomes and accidents not only cannot be ruled out, but in fact are common through history.

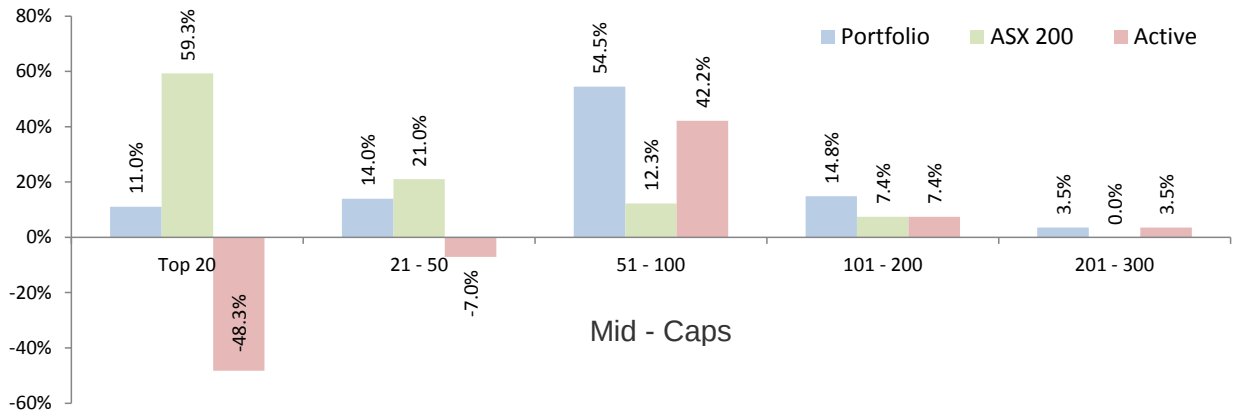
Equity markets and investors have never been good at pricing in geopolitical risks and tensions are likely to persist for years to come.

We would prefer to focus on our areas of expertise, stick to stock picking and leave the unpredictable geopolitics to the experts. We have maintained what we believe to be a prudent level of Index Put Protection, where insurance is cheap and implied volatility remains at historical low levels, despite the elevated risks highlighted above and general level of investor complacency.

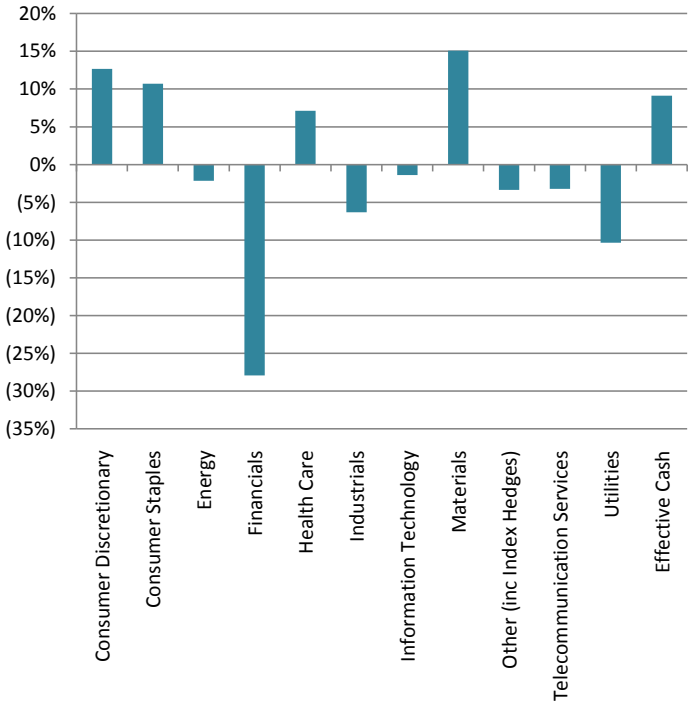
Warm Regards,

Chris Kourtis
Portfolio Manager

SIZE Comparison Chart vs ASX 200



Active Sector Exposures*



* Active sector exposures are determined by subtracting fund sector weights from benchmark weights. Positive percentages represent over-weight sector exposures relative to benchmark and negative percentages represent under-weight sector exposures relative to the benchmark.

Core Holdings

BHP BILLITON
DULUXGROUP
GRAINCORP
HEALTHSCOPE
LINK ADMINISTRATION HOLDINGS
NUFARM
PRIMARY HEALTH CARE
RIO TINTO
STAR ENTERTAINMENT GROUP
TREASURY WINE ESTATES

Asset Class Exposures

Exposure (% NAV)	Net
Equity	94.2%
Long Option	0.0%
Short Option	(3.3%)
Effective Cash	9.1%
Grand Total	100.0%

About the Ellerston Overlay Australian Share Fund

The Fund aims to achieve its performance objectives by adopting a fundamental "bottom-up" investment approach to stock selection whilst delivering additional income where possible, through option strategies.

Because of the nature of the strategy, at least 75% of the Fund's exposure is aligned to the portfolio of the Ellerston Australian Share Fund.

The Investment opportunities for the Fund are identified by analysing and understanding the factors affecting (amongst other things): business model, industry structure, management team and overall valuation.

Ellerston Capital typically favours businesses that can sustain high returns or improve their return on capital and looks to invest in businesses with a market value below the value we attribute to them.

Benchmark weightings do not drive our stock decisions; our approach is totally benchmark independent.

Strategy Funds Under Management	$208 Million
Funds Under Management - Overlay ASF	$24 Million
Application Price	$1.1030
Redemption Price	$1.0975
Number of Stocks	18
Inception Date	4 January 2012

Note: Unit prices reflect Class A only.

DISCLAIMER
This newsletter has been prepared without taking account the objectives, financial situation or needs of individuals. Before making an investment decision about the Ellerston Overlay ASF (**Fund**) you should read the Fund's Information Memorandum dated 11 January 2012 which can be obtained by contacting info@ellerstoncapital.com and obtain advice from an appropriate financial adviser. Units in the Fund are issued by Ellerston Capital Limited. This information is current as at the date on the first page. The inception date for the Fund is 4 January 2012.

This material has been prepared based on information believed to be accurate at the time of publication. Assumptions and estimates may have been made which may prove not to be accurate. Ellerston Capital undertakes no responsibility to correct any such inaccuracy. Subsequent changes in circumstances may occur at any time and may impact the accuracy of the information. To the full extent permitted by law, none of Ellerston Capital Limited, or any member of the Ellerston Capital Limited Group of companies makes any warranty as to the accuracy or completeness of the information in this newsletter and disclaims all liability that may arise due to any information contained in this newsletter being inaccurate, unreliable or incomplete.

Past performance is not a reliable indicator of future performance.