Ellerston Australian Share Fund

PERFORMANCE REPORT November 2017

The investment objective of the Ellerston Australian Share Fund is to outperform the S&P/ASX 200 Accumulation Index (Benchmark). The Fund aims to achieve this by investing in a concentrated portfolio of no more than 25 Australian listed securities.

Ellerston Australian Share Fund Performance to 30 November 2017

	Gross	Benchmark*	Excess	Net
1 Month	2.32%	1.64%	0.68%	2.25%
3 Months	7.76%	5.71%	2.05%	7.50%
Rolling 12 Months	14.14%	14.62%	(0.48%)	12.94%
2 Years (p.a.)	15.14%	12.30%	2.84%	13.91%
3 Years (p.a.)	11.40%	8.72%	2.68%	10.21%
5 Years (p.a.)	11.80%	10.56%	1.24%	10.63%
Since Inception (p.a.)	11.45%	10.65%	0.80%	10.25%
Since Inception (CUM)	155.81%	140.41%	15.40%	132.91%

The return figures are calculated using the redemption price for Class A Units and on the basis that distributions are reinvested. The Gross and Excess return figures are before fees and expenses whereas the Net Return figures are net of fees and expenses for the Class A Units. Returns of the Fund may include audited and un-audited results.

Past performance is not a reliable indicator of future performance. * The benchmark was changed from the S&P/ASX 200 Accumulation Ex REITS Index to the S&P/ASX 200 Accumulation Index on 1 July 2012.

Market Commentary

In November, with the US market doing a lot of the heavy lifting, most world equity markets continued to deliver positive returns. Eurozone equities bucked the trend and underperformed the rest of the world, despite strong economic data coming out of the region. Markets were spurred on by continued evidence of synchronised global growth, a falling US Dollar and upward earnings revisions, but were also tempered by pockets of geopolitical uncertainty.

Equity markets in the US were stronger, with the Dow Jones Industrial Average Index punching through the psychological 24,000 threshold for the first time (up 3.8% in November). The S&P500 Index (up 3.1%) also hit fresh highs as investor sentiment and confidence in the strengthening economy firmed. US equity markets were driven higher by buoyant retail sales pushing up consumer-focused sectors, with Wal-Mart surging (+11.4%) after beating earnings expectations and Amazon also continuing to power ahead (+6.5%). Ongoing strength from the technology and financial sectors also fueled the market. Financial stocks were well bid after newly appointed Fed Chairman Jerome Powell said that the current regulations on the sector were "tough enough", adding that he favoured the "tailoring" of regulations to alleviate the burden placed on smaller banks.

There was also increased optimism that the much talked about US tax reform package would become a reality, after the US House of Representatives finally passed the tax reform bill. In early December, President Trump secured a major political victory when his controversial tax reform legislation got through the Senate.

The release of the minutes of the last meeting of the Federal Open Market Committee confirmed that "labour market conditions generally continued to strengthen and that real gross domestic product (GDP) expanded at a solid pace in the third quarter, despite hurricane-related disruptions”. The minutes also noted that real GDP was expected to rise at a solid pace in the fourth quarter, boosted in part by a rebound in spending and production after the negative effects of the hurricanes in the third quarter were reversed.

In Europe, the Eurozone flash PMI for November rose to a much better-than-expected 57.5 (a 79 month high), but despite a raft of positive economic data points, political uncertainty featured again, weighing down investor sentiment. Germany was thrown into political disarray following the collapse of talks to form a coalition government. Chancellor Angela Merkel’s conservative Christian Democratic Union party is now in fresh talks with its old partner, the Social Democratic party, to form a “grand coalition”. Ireland narrowly avoided a political crisis from a policing scandal that could have caused the collapse of the minority government. Spain continued to work its way through the tricky situation of Catalonia wanting independence from Madrid’s control, with seemingly little progress made during the period.

Against this muddied backdrop, it was a poor month for European equities with the Euro Stoxx 50 down -2.8%, and the French and German markets down -2.4% and -1.6% respectively. The Spanish equity market was the worst performer in the region, down almost 3.0%. Only the Swiss market bucked the trend, rising 0.8%.

In the UK, the government delivered its autumn budget which contained fairly bleak economic forecasts. In particular, the growth rate for the current year was slashed to 1.5% (from 2% as recently as March 2017). More worryingly, growth forecasts for the medium term were also cut, with the UK economy forecast to grow on average at just below 1.5% over the next four years. The Bank of England raised rates by 25 basis points to 0.5% - the first rate hike in over 10 years and the FTSE100 ended the month down 2.2%.

Asian market performance proved to be a mixed bag, with the Nikkei up 3.2% and the Hang Seng up 3.3%, while the Chinese Shanghai Composite market fell 2.2%, with South Korea falling 1.9%. The markets in Asia traded mixed on the back of expanding global growth and better regional corporate earnings delivery. However they were also plagued by persisting geopolitical tensions in the region, as the US Pentagon confirmed that North Korea again fired a missile that travelled over 1,000 kilometers before crashing into the Sea of Japan.

The big bond story for November was flattening yield curves around the globe, while the weakening US Dollar and strengthening Euro were the main stories within forex markets.

On the commodities front, iron ore rallied over US$10 a ton to US$68.50 a ton, while Brent crude advanced $US2.20 to US$63.57 a barrel after OPEC and non-OPEC producers (led by Russia), agreed to extend oil output cuts until the end of 2018. The 6.0% rally in crude in November, leading to gains of 22% over the past 3 months, was a welcome relief for global energy shares.

In Australia, the political fortunes of the government didn’t improve, with the Liberal party's popularity, as measured by the opinion polls, continuing to tumble. **The S&P/ASX 200 Accumulation Index once again seemingly ignored the politics and finished up 1.64% in the month,** reaching its highest level since January 2008. Investors kept their faith and took comfort in firming global growth, benign inflation, low interest rates and stronger earnings expectations.

The big news domestically broke on the last day of the month when speculation around a Royal Commission into the financial sector ended after the Prime Minister, Malcolm Turnbull, succumbed to political pressure and announced an inquiry into the banking, superannuation and financial services industries. The Royal Commission headed by a former High Court judge, will have a 12-month reporting period, with the draft terms of reference limiting the scope of the inquiry to primarily conduct issues. It will not address matters covered by other inquiries like competition and pricing, macroprudential policy, regulation or oversight. The draft terms of reference noted that the Commission will not inquire into matters that might prejudice, compromise or duplicate any other inquiries. While the announcement removes uncertainty, the Royal Commission itself will be a costly exercise for the financial institutions and likely distract management. It's very hard to speculate on the likely impact of the inquiry at this very early stage. Suffice to say that this would confirm and probably worsen the negative sentiment toward the financial sector, and the banks in particular. The media will no doubt be unsympathetic towards the banks and will probably be seeking blood.

Not surprisingly, the Reserve Bank of Australia kept rates on hold for the 14th consecutive month at its November meeting and was also more upbeat on domestic and international growth in the commentary that accompanied the rates decision.

The main drivers of the S&P/ASX 200 Index in November were Commonwealth Bank (+20 points), BHP (+16 points), Wesfarmers (+15 points), CSL (+13 points), Origin Energy (+11 points) and Insurance Australia Group (+9 points). The main detractors from the index were the three major banks - National Australia Bank (-35 points), Westpac (-13 points) and ANZ Bank (-12 points), also Orica (-9 points), following a disappointing full year result and Telstra (-8 points) continuing its poor run.

The best performing S&P/ASX 100 Index stocks during the month included Santos, after a takeover proposal was received and rejected by the Board (+12.9%), Origin Energy (+12.5%), Northern Star Resources (+11.7%), TPG Telecom (+10.2%) and Insurance Australia Group (+9.3%). The worst performers were Orica (-17.3%), Corporate Travel (-15.4%), ALS Limited (-12.7%), Graincorp (-8.7%), Qantas (-7.8%) and National Australia Bank (-6.5%).

Small caps again outperformed their larger cap peers, with the Small Ordinaries Accumulation Index returning 3.9%. Small Industrials Accumulation Index advanced 2.8% and Small Resources Accumulation Index finished up 8.1%, led by Obocobre (ORE up an astonishing 29.3%) and followed by other lithium "thundering herd" securities.

Telecommunication and Financials were the worst performing sectors in November, returning -1.6% and 0.0% respectively, while the Real Estate, Information Technology and Energy sectors took line honours returning 4.7%, 4.4% and 4.0% respectively.

Company Specific News

The Misses

Webjet (WEB -17.7%)

Webjet got the wooden spoon as the worst performer in the ASX 200 Index after it provided guidance at its AGM for EBITDA of $80.0m in FY18, which was at least 10% below consensus. Whilst TTV guidance was in-line at $3.0bn. cost headwinds - including transaction costs from the acquisition of JacTravel, additional support for Thomas Cook and the 'Netflix Tax' in relation to Online Republic negatively impacted the bottom line. On a P/E multiple of 23x before the sell-off, it certainly wasn't priced to disappoint.

Orica (ORI -17.3%)

Orica's FY17 results were softer than expected at the headline level, with EBIT of $635 million which was circa $10 million below consensus. Whilst the miss was modest, it was more the cautious guidance for FY18 that underwhelmed investors. The company suggested that total ammonium nitrate volumes would be between -5% to +5% on the 3.65 million tons delivered in FY17, a disappointing outcome given the heightened activity for the miners and indications that major customers were in fact increasing their pre-strip ratios. Moreover the company's decision to expense R&D and rollout of its new SAP systems impacted the numbers by $40 million, catching everyone unaware.

Nanosonics (NAN -15.3%)

Technology companies trading on 70x earnings are not allowed to disappoint even modestly. As Nansonics builds out its UK operations, it is providing sterilization equipment into hospitals without an initial capital charge. This, combined with an increased R&D charge in FY18, saw earnings cut across the board.

Baby Bunting (BBN -12.7%)

Baby Bunting fell after the company released a trading update which showed consolidation and related clearance activity was causing major short term price deflation and margin compression.

ALS Limited (ALQ -12.7%)

ALS Limited reported a first half result in which NPAT was at the lower end of recent company guidance, but the sting in the tail was the FY18 guidance of between $135 -$145m, which was way below consensus expectations. Investors were rightly underwhelmed and the stock sank 7.4% on the day of the release.

Aristocrat Leisure (ALL -6.6%)

Despite reporting very solid FY17 net profit after tax and amortization of $543 million, up an impressive 36% on the prior corresponding period and 1% ahead of expectations, the Aristocrat share price declined in the period. The major concern for investors was a slowdown in class 3 participation boxes in 2H17. The outlook statement suggested continued growth in North America, a flat outcome for Australia and lower earnings from class 3 international, mainly as a result of lower new openings in 2018. Aristocrat also announced the acquisition of social gaming company Big Fish for US$990 million in cash, implying an adjusted multiple of 11.9x EBITDA for the last twelve months. Big Fish is a wholly owned subsidiary of Churchill Downs Incorporated, which had acquired Big Fish back in 2014 for only 8.5x EBITDA. The market didn't like the transaction and the stock was sold down sharply, ending the day down 6.8%, having traded down 10% at its low.

Mayne Pharma (MYX -5.8%)

Another company to endure a tough AGM was Mayne Pharma. After a horrendous 12 months which included two downgrades in August, there was hope that FY18 might see the company finally turn the corner. Alas this was not the case, as price deflation in the generic drugs segment saw revenue to October fall 12%. In addition, the company announced that the CEO would be selling up to 5 million shares - never a great signal considering the stock price has fallen 64% in the last twelve months and is trading on its lows.

Telstra (TLS -3.1%)

Telstra had another horrible month, with the shares now down circa 27% since the beginning of the calendar year. Impacting the share price this month was the surprising news that NBN Co was halting the roll-out of HCF instalments for 6-9 months. Telstra receives one-off payments for each customer transferring to the NBN and as such will have lower revenue and profits in FY18 and FY19 as a result. Post month end, the company lowered its EBITDA guidance by $600 million as a result of the delay in rollout.

Oroton Group (ORL - suspended and in administration)

The difficulty for small retailers in Australia continued, with Oroton, the handbag retailer, going into administration, becoming another high profile casualty in Australia's retail bloodbath. Its shares have been suspended. Oroton's stores will continue to trade while the administrators pursue a sale or a recapitalisation. In the past 18 months, Marcs, David Lawrence, Herringbone, Rhodes & Beckett, Payless Shoes and Pumpkin Patch have all gone under. Specialty Fashion Group also announced that it was closing approximately 300 of its 1,000 stores.

The Hits

AWE (AWE +31.4%)

AWE received an unsolicited, non-binding, indicative and conditional cash offer from China Energy Reserve and Chemical Group (CERCG) to purchase 100% of the business at $0.71 per share. CERCG appear to be making the offer to secure the key operatorship for the Waitsia conventional gas project in the onshore Perth Basin. The offer was pitched at a 30% premium to the last closing price, but remains conditional on further due diligence, FIRB approval, execution of the Implementation Agreement and approval by CERCG's Board, therefore has no guarantee of success. With approximately 80mmboe of 2P reserves, following the increase at Waitsia volumes to over 400 PJs earlier this month, and an assumed 100% take-up of the SPP for AWE stock (capped at $10 million), it is estimated that the offer by the Chinese reflects a valuation of ~$5.50/boe. The Company indicated that the Board would need more time to review the offer, but at this point, would not allow due diligence. The market is likely to adopt a wait and see approach at the prospect of whether or not this bid actually comes to fruition, or whether it could flush out a counter bidder/bidders in the future. The situation remains uncertain, but none the less, the stock closed up 22.9% to 67 cents on the day of the bid.

Speedcast (SDA +24.5%)

Speedcast is a leading satellite service provider in both remote regions and in maritime situations, particularly offshore drilling and cruise ships. With the energy sector rebounding and the company executing on extracting synergies from its recent acquisition, Harris Caprock, earnings momentum is starting to build.

NextDC (NXT +12.8%)

NextDC is Australia's leading data centre provider with locations across the eastern seaboard and in Perth. NextDC announced it was bringing on a further 22 megawatts of capacity across its network by enhancing capacity in existing and new facilities. With impressive growth driven by demand from cloud technology, outsourcing and desire for co-location it is truly seen as a unique opportunity for investors with high barriers to entry.

Origin Energy (ORG +12.5%)

Origin Energy presented its strategy day with much of the focus on the cost out opportunity at its APLNG operations on Curtis Island in Queensland. Currently running at a breakeven oil price of US$48/boe, the $500 million cost out program will reduce that number to less than US$40boe. This not only drives significant earnings upside, but it continues to de-risk the company that was until recently carrying a burdensome amount of debt. Balance sheet repair has been the theme of the last few years and the company, under a new management team, now appears on track to restart dividend payments in FY19.

Monadelphous (MND +10.3%)

At its AGM, Monadelphous's management guided to significant top-line growth of 30% year-on-year. New contracts and a spike in activity from the Ichthys project, drove the upgrade. This extends Monadelphous' stellar run, up 77% over the last 12 months, as investors rushed back into engineering and construction services exposed to the rebounding mining and energy sectors.

Vocus Group/TPG Telecom (VOC +9.0%/TPM +10.2%)

Telstra's loss appears to be both Vocus Group's and TPG Telecom's gain. Whilst a slowdown in the roll-out of the NBN impacts payments to TLS, it assists both smaller internet providers by keeping customers on the cheaper copper network and protecting margins. Whilst the benefit will be fairly short run, it reduces the stress on TPM's balance sheet as its rolls out its new mobile network in Singapore and Australia.

Dulux (DLX +9.4%)

During the month, DuluxGroup reported a very solid FY17 result with NPAT of $142.9 million growing 9.6% on the prior corresponding period and exceeding market expectations. The core paint business performed well, with continued delivery of resilient growth - profit and dividend growth every half since the demerger in 2010. Selleys reported double digit earnings growth, however the real positive surprise came from the strong performance in the problematic Alesco businesses, which is now displaying earnings momentum, with B&D EBIT +13% and Lincoln Sentry +16%. The outlook commentary was consistent as is the norm, with management guiding to higher earnings in FY18 subject to economic conditions.

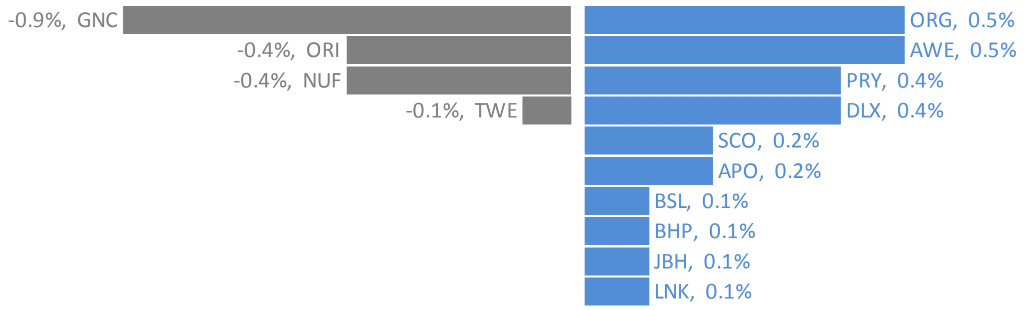
On the corporate development front, the company also provided an encouraging update on its UK entry, with the Selleys range having been launched into all Bunnings and Homebase stores. DuluxGroup also announced the signing of a new Selleys JV in Indonesia with Avian, a leading Indonesian paint manufacturer and hardware distributor. The market liked this capital-light and low risk expansion opportunity. On the flip side, the only negative was that the DGL Camel China JV underperformed and the company has announced a strategic review.

Performance

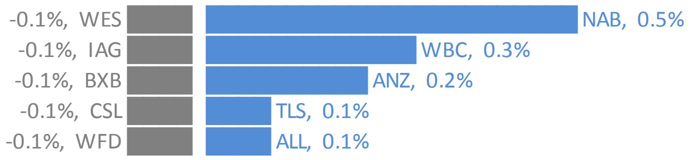
Following a very strong month in October where performance snapped back quickly, it was pleasing to see the Fund continue to deliver positive returns and consolidate the gains in the month of November.

The Fund's return of +2.32% comfortably outperformed the benchmark return of +1.64% and was broadly driven by a number of our Core holdings rallying, coupled with being underweight Financials (zero Banks) which underperformed the market.

Securities Held



Securities Not Held



The main contributors to this month's performance were overweight positions in AWE (+31.4%), Origin Energy (ORG +12.5%), Dulux (DLX +9.4%), Primary Healthcare (PRY +7.9%), Star Entertainment (SGR + 3.0%) and Link Market Services (LNK +3.4%), while having a zero weight in both NAB (-6.5%) and ANZ (-2.3%) also had a positive impact on performance.

The main detractors were overweights in Orica (- 17.3%), and GrainCorp (- 8.7%), both of which underperformed the broader market after delivering an earnings report card that slightly missed expectations.

Activity

The Fund was highly active during the month of November.

Despite our best endeavours, given the extremely tight supply situation and exceptionally strong demand, we received only a small (almost a rounding error) allocation in the initial public offering (IPO) of **Netwealth Group Limited**. Despite this tiny allocation, we present our investment thesis below to provide the rationale for pursuing this growth opportunity.

There were also other portfolio adjustments, as we took profits in some holdings that continued to rally hard (namely **Star Entertainment**, **Dulux, Rio Tinto** and **Link**) and strengthened a select number of the portfolio's existing positions (namely **Bluescope**, **Origin** and **JB Hi Fi**).

Having divested the bulk of the Fund's holding in **Orica** a few months back at frothy levels, following the release of their full year result (which missed expectations), we used the sharp sell off as a buying opportunity. The main cause of the earnings miss for FY17 was the $40 million expensing of previously capitalised R&D and systems development (not well communicated) and the re-pricing impact of existing contracts (circa $55 million), both of which were broadly offset by management's continuous improvement and cost cutting initiatives. We believe these issues have run their course and should not act as a drag in future years. Given the mining cycle is in an upswing and volumes are recovering, ORI should benefit. Coupled with the ammonium nitrate plant operated by Yarra in Western Australia which is ramping up progressively in 2018, the result just released should hopefully mark the bottom.

Netwealth Group Limited

Netwealth Group Limited (NWL) is the largest specialty platform provider in Australia with approximately $16 billion in funds under management and administration (FUMA), having grown rapidly over the past five years. NWL operates in an industry with attractive growth prospects that should benefit from the structural shift away from the big banks towards specialist niche platform providers.

The company has a track record of delivering significant growth, solid profitability and high cash generation. Across the platform market, NWL has only 1.7% market share but captured an astonishing 19% of all flows in FY17. The opportunity to capture higher market share remains significant. NWL is recognised by planners as having a market leading platform in terms of technology and service offering. It has a diversified client base with no individual client having more than 6% of its funds under administration.

NWL offers a range of products and services, which drive multiple sources of revenue for the group. It offers products and services across Superannuation, Wrap and Managed Investment Schemes. Administration fees represented approximately 61% of total platform revenue in FY17 and ancillary fees represented 32% of revenue, with transaction fees (4%) and management fees (3%) making up the rest. Non-administration fee contributions are expected to increase over time as NWL monetises platform funds under administration from other revenue sources. The company claims that over 90% of the revenue is recurring and financial intermediaries exhibit a high degree of "stickiness". In mid-2017, NWL had 38% of its financial intermediary users' funds under advice on its platform. This compared to over 60% in the industry. This presents a substantial growth opportunity for NWL as financial intermediaries consolidate and transition a higher proportion of their funds onto the NWL platform.

In addition to growth in funds from existing clients, the group is expected to grow funds rapidly from new advisors joining its platform. The main operating expenses of the group are staff costs, particularly IT staff costs. NWL has also incurred marketing, consulting and legal expenses as it increased brand awareness and prepared for its listing. While IT-related expenses will be an important cost variable going forward, if the group is to maintain its leadership position, in the medium term, no significant spike in expenses is expected. The significant growth in funds driving revenue growth ahead of cost growth and the benefits of scale should see a steady increase in EBITDA margins to over 50%.

Low working capital requirements, limited capital expenditure, no amortisation and no debt should see the group continue to be highly cash generative.

We decided to participate in the IPO of NWL as it is a highly cash generative and profitable business with significant growth opportunities and a very capable management team, in an industry with attractive fundamentals. Additionally, as just under 30% of the share capital was offered to the market (with only ~$130m available for institutions such as ourselves and the rest to retail investors), it was likely to be well bid given its attractive fundamentals and the scarcity of stock.

The IPO was priced at $3.70 which was the top end of the indicative range and valued the company at an eye-watering 32x FY18 forecast earnings (which normally warrants caution, as there is no room for error). However, given the strong growth in FUMA (driven by growth in assets on its platform and the shift away from the banks to independent players like NWL) and steadily increasing EBITDA margins (as costs were under control and the benefits of scale emerged), forward multiples were more attractive at 24x FY19 and 19x FY20, justifying the initial investment.

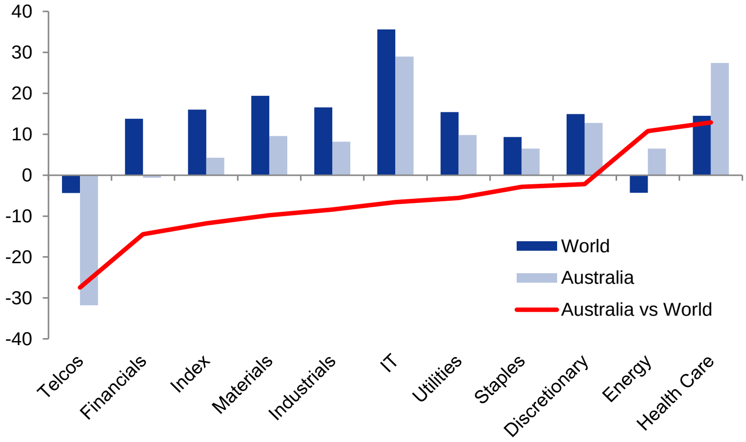
The stock listed on 20 November 2017 and closed the first day of trading up almost 44%.

Strategy and Outlook

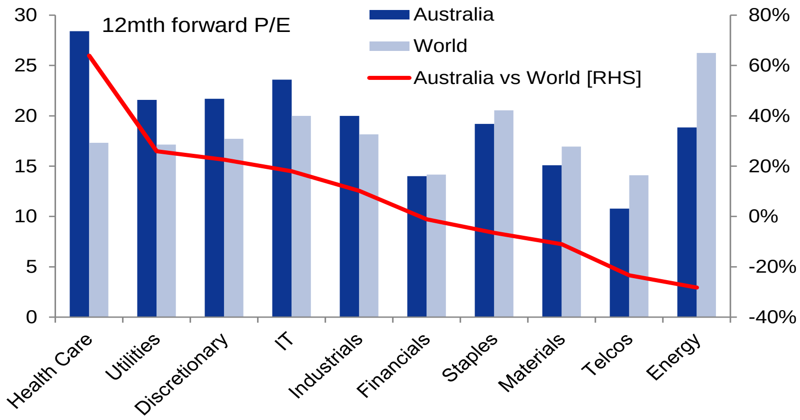
After lagging global markets for the CYTD, the Australian market continues to catch up, delivering another month of positive returns in November. As we mentioned last month, recent outperformance has been driven largely by stocks being re-rated.

Australia vs MSCI World

- Australia has been one of the worst performing equity markets this year, up 9.8% CYTD, underperforming the MSCI World (+17.2%)

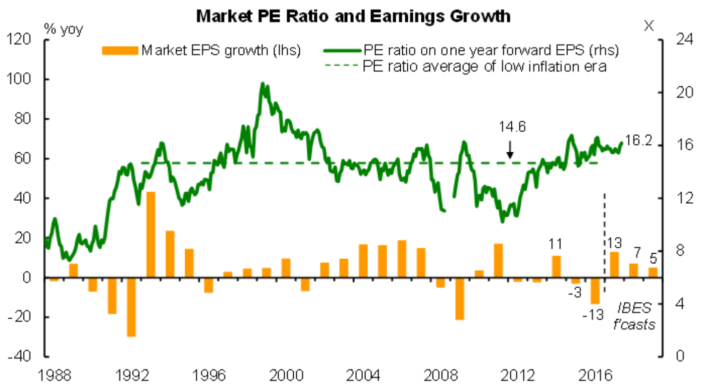


- While Australia's small tech sector has had a strong year (+20% vs. +30% globally), its small index position (50bps vs. ~15% globally) has partially driven the underperformance

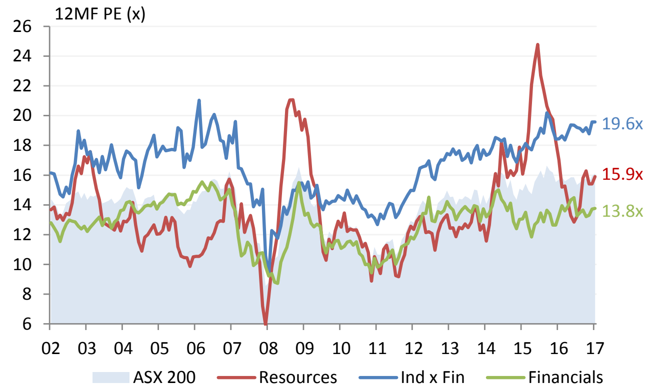


Source: Bloomberg, MSCI, Goldman Sachs. November 2017

Current market valuations are slightly above fair value based on longer term averages. The market multiples are at a ~7% premium to its long-term average, with the Industrials (ex-financials) at 19.6x and the ASX 200 at 15.9x.



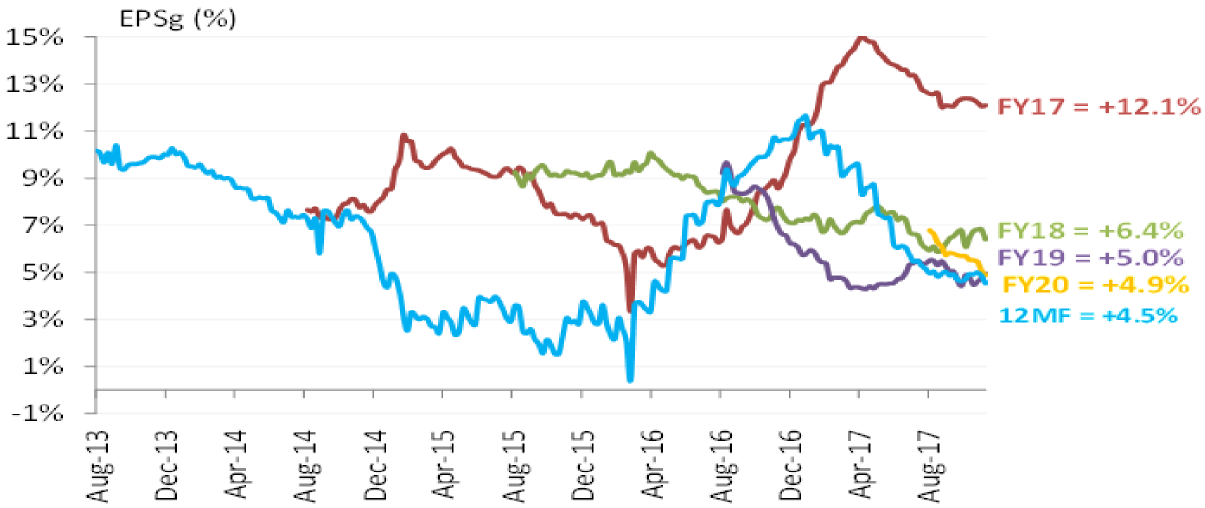
Source: IBEX, S&P, Datastream, Citi Research. November 2017



Source: RIMES, IBES, Morgan Stanley Research. November 2017

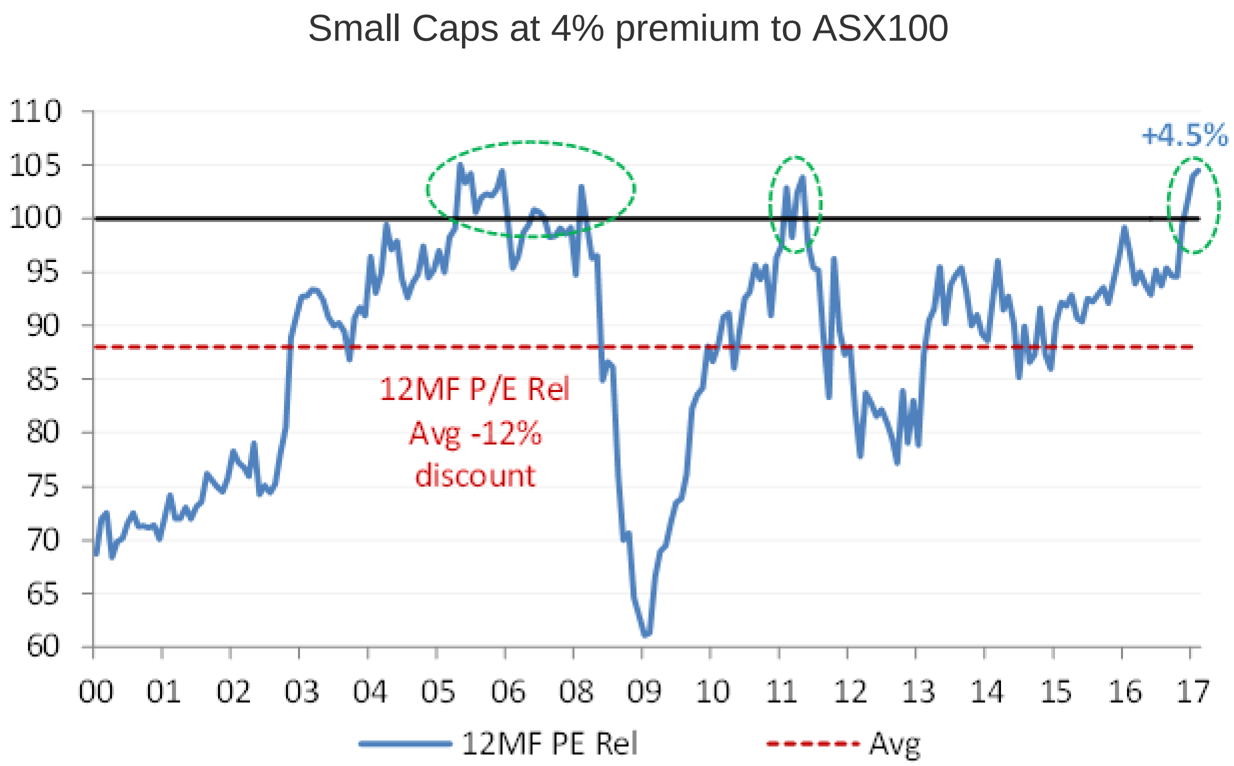
Despite experiencing strength in April and May, earnings per share growth in materials stabilised, with consensus forecasts for FY17 settling at 12.1%. FY18 earnings are now forecast to increase by 6.4%, a modest downgrade from last month. FY19 earnings growth is now forecast to be 5% given the lack of growth within industrials more broadly.

EPS Growth for FY17 was +12.1%



Source: RIMES, IBES, Morgan Stanley Research. November 2017

The Small Ordinaries continue to trade at a premium to the ASX 100. The outperformance of the Small Ordinaries index has been narrowly based with the 20 best performing stocks returning +86% (on average) over the past six months, contributing to 84% of the increase in the index. **The remaining 180 stocks have returned just over 1%** over the same period and have contributed to only 16% of the increase in the index.



Source: RIMES, IBES, Morgan Stanley Research. November 2017

As mentioned in the activity section, we have continued with our current strategy of investing primarily outside the Top 20 where we see the best opportunities and have been adding to stocks which we believe are mis-priced, trading at discounts to our valuation and are supported by reasonable earnings growth. We currently hold two Top 20 stocks, namely BHP Billion and Rio Tinto.

We target the best opportunities we see in the market through the following segmented portfolio positioning strategy.

- ***Quality Franchises with defensive characteristics,*** solid companies with strong market positions, credible management and good balance sheets: Treasury Wines, Dulux and Link Administration.
- ***Quality Businesses that are cyclical in nature,*** companies with strong market positions and strategic assets, but sensitive to economic conditions and seasonality: Graincorp, Nufarm, JH Bi-Fi and Star entertainment.
- ***Turnaround Stories,*** sound businesses that have historically generated poor returns or under-earned versus their potential, are in transition and where we think earnings/returns will improve over the medium term: Primary Healthcare and Healthscope.
- ***Deep Value Cyclical and Resource Plays,*** stocks trading at discounts to NPVs, with self-help & growth optionality, at the bottom of, or turning point in the cycle: Rio Tinto, BHP, BlueScope Steel and Origin Energy.

As you will be aware, we continue to remain zero weighted to the banks. Our rationale for this position is below.

1. **Compelling value elsewhere**: We see opportunities to capture alpha in other segments of the market which offer superior earnings per share growth. Australian banks don't look cheap in an international context either.
2. **Top line growth under pressure**: Lending growth has slowed (expected to be in the low single digits) as households borrow less, macro prudential constraints take full effect and businesses need less debt. This will constrain revenue growth.
3. **Australian consumers are amongst the most leveraged in the world**: Debt serviceability is important, but we are more concerned that the level of household debt is extremely high. At over 200% of disposable income (according to the latest OECD data), Australia has the fourth highest level of household debt. Put in the context of high asset prices and the prospect of interest rates nudging higher in the next year or so, this does not bode well for the credit cycle.
4. **The bad debt cycle or lack of it**: Credit charges for the sector are at historically low levels and declining charges have been the key contributor to earnings. The banks have indicated that they don't see evidence of stress apart from in Queensland and Western Australia. We don't believe declining levels of impairment charges are sustainable. And the banks are running out of write-backs. Forward earnings estimates have only modest increases in bad debt charges. Our experience and international markets would suggest that this could be optimistic.
5. **Higher bank levies**: The febrile political environment and the government's inability to pass legislation to accelerate budget repair could leave the banks vulnerable to a further increase in the bank levy. This will hurt margins and profits.
6. **The pending Royal Commission**: The government has succumbed to political pressure and announced that it will be holding a Royal Commission into misconduct in the banking, superannuation and financial services industries. While the Royal Commission extends beyond the banks and is narrowly focused currently, it will be costly, distracting and negative for sentiment.
7. **Declining returns**: It is difficult to see ROEs sustained at current levels over the medium-term given the cyclical and structural headwinds facing the banks.
8. **Disruptors**: The threat of disruptors is real.

Banks: Australian Big 4 vs Chinese Big 4

Chinese Banks, same Dividend Yield, but no Franking.

- Same ROE.
- Double the Growth with half the PE.
- It's tough competing for investment dollars, when you're up against competitors like this!

Big 4 Average	PE	Div. Yield	BVPS* Growth	P/Book	ROE
Australia*	13.2x	5.7%	4%	1.8x	13.6%
China*	5.5x	5.4%	10%	0.7x	13.3%

*BVPS is Book Value per Share.
Big 4 Australian banks are CBA, ANZ, Westpac and NAB. Avg mkt cap of $107b.
Big 4 Chinese banks are CCB, ICBC, BOC and ABC. Avg mkt cap of $289b.
Data as of Oct 24 for forward FY. Source: Bloomberg.

Outlook for 2018: Risks in a Maturing Cycle

Major uncertainties are: the effect of central bank tapering, tighter monetary and financial conditions, ever-present geo-political tensions and the rising risk of a trade war.

We will monitor closely the macro commentary emerging from the central banks. So far, the updates from the Federal Reserve and the Reserve Bank of Australia have confirmed synchronised global growth with inflation still broadly in check. The political uncertainty in Europe has impacted investor sentiment in the short term, but economic growth forecasts (with the exception of the UK) continue to firm.

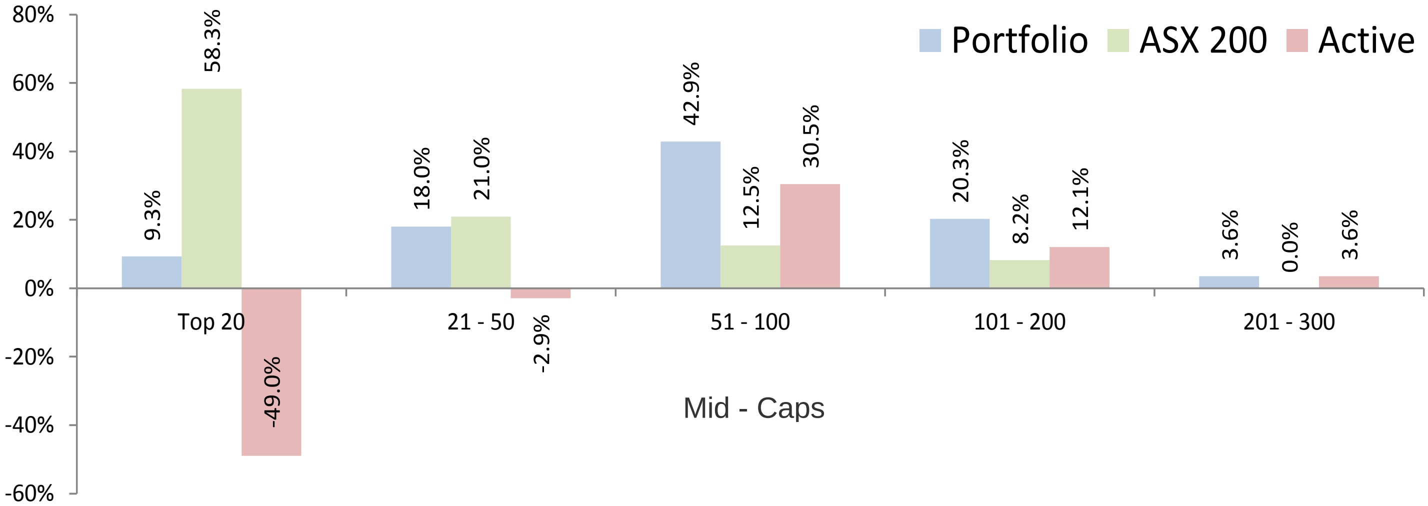
We are still of the view that US interest rates will nudge higher over the course of 2018, and remain alert to the prospects of higher rates resulting in a potential valuation-driven correction to equity markets. In the meantime, the music plays on and so we dance.

Warm Regards,

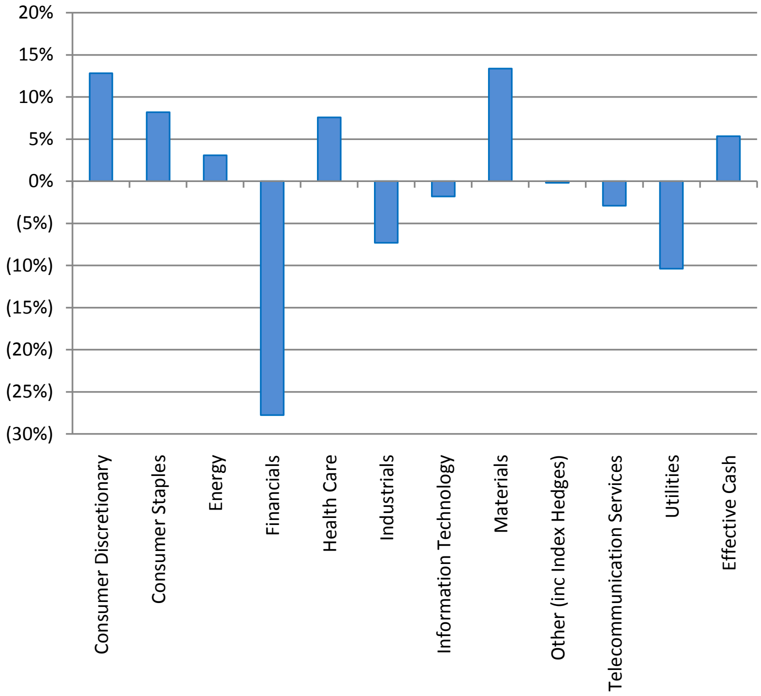
Chris Kourtis

Portfolio Manager

Size comparison Chart vs ASX 200



Active Sector Exposures*



Top 10 Holdings

APN OUTDOOR GROUP

GRAINCORP

HEALTHSCOPE

JB HI-FI

NUFARM

ORICA

ORIGIN ENERGY

PRIMARY HEALTH CARE

STAR ENTERTAINMENT GROUP

TREASURY WINE ESTATES

* 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.

About the Ellerston Australian Share Fund

The Fund aims to achieve its performance objectives by adopting a fundamental “bottom-up” investment approach to stock selection which is focused on identifying and then constructing a portfolio of the highest conviction ideas.

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.

Due to the high conviction nature of the portfolio and the resulting deviation in portfolio composition relative to benchmark weighting, it is expected that the returns from the Fund will differ significantly from the broader market indices.

Fund Facts

Strategy Funds Under Management	$3.20 Billion
Funds Under Management - ASF Unit Trust	$50 Million
Application Price	$1.0678
Redemption Price	$1.0624
Number of Stocks	19
Inception Date	1 April 2009