ELLERSTON CAPITAL

Ellerston Australian Market Neutral Fund

PERFORMANCE REPORT February 2018

Fund performance^ (Net)

Net	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
2018	-0.03%	0.54%											0.52%
2017	0.54%	-0.98%	0.47%	-0.01%	-0.57%	1.64%	-0.40%	0.87%	0.12%	1.09%	-0.20%	2.14%	4.76%
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	0.54%	0.11%	0.43%	0.74%	Positive months	75%
3 Months	2.66%	0.37%	2.29%	3.45%	No. Relative Value positions	91
6 Months	3.70%	0.74%	2.96%	5.00%	No. Special Situations	34
1 Year	5.77%	1.50%	4.27 %	8.02%	Net Equity Exposure	+24.5%
2 Years p.a	5.69%	1.57%	4.12%	8.15%	Gross Portfolio Exposure	161.7%
3 Years p.a	6.32%	1.73%	4.59%	8.88%	Beta Adjusted	3.4%
Since inception p.a	9.83%	2.02%	7.81%	13.21%	Correlation Coefficient (vs ASX 200 Accum)	-8.95%
					Net Sharpe Ratio (RFR = RBA Cash)	2.10

Performance

In what was a tricky reporting season, the Fund returned +0.5% (net) during February, compared with the benchmark return of +0.1%. Net exposure closed the month at +24.5% with a beta-adjusted net of +3.4%. The gross exposure of the Fund modestly increased, closing the month at 161.7%.

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Retirement Village operator Aveo Group (+1.1%) reported a 1H18 result that missed consensus earnings expectations, but importantly showed signs of recovery following a torrid six month period for the company. Specifically, the company reported that sales in the first two months of 2018 have normalised following the Fairfax Media campaign in 2017. Whilst there still remains an outstanding class action and potential ACCC investigation, we believe that the worst is behind them and see NTA growth to $4.00 over the next 16 months. The market seemed to agree, with the stock trading higher in the month, outperforming most REIT peers and adding value to the Fund.

After years of disappointing the market, Ingenia Communities (+4.1%) finally presented a result that was clean, met guidance and led to an upgrade to consensus EPS in both FY18 and FY19. The company was rewarded with a share price that outperformed the sector by more than 7% in the period and its most relevant peer, Gateway Lifestyle (-5.6%) - by almost 10%. Our holding in Ingenia added to performance in February. The position was hedged with a short in Mirvac (-3.6%), and was the largest positive contributor in the period.

Our success with Ingenia was partially negated by paired positions featuring a long in Gateway, hedged with Goodman Group (+1.5%) and Growthpoint Properties (+0.6%). The Gateway result was in line with expectations, however a large institutional shareholder was forced to liquidate their position during the month, forcing the share price lower.

Despite a strengthening GBP in February, the spread between the Australian and UK listings of BHP Billiton (+1.0%) and Rio Tinto (+5.6%) widened, detracting from the performance of the Fund. The GBPAUD cross-rate closed the month at 1.78 from 1.75 at the end of January.

Superloop (-8.2%) reported mixed results during February, with profitability better than market expectations but growth slower and the result bolstered by one-offs. Superloop owns dark-fibre networks on the East Coast of Australia, Hong Kong and Singapore as well as a Fixed Wireless Broadband Network. The company is leveraged to demand for data transmission and therefore the theme of growing data consumption and cloud computing.

Despite the share price of Nufarm (+3.9%) rising in the period, the Nufarm notes (-2.8%) traded lower, with our long position detracting value from the Fund. There was little news during the month, with the company scheduled to report on their 1H18 results in March.

Activity

Relative Value – Gross Contribution 1.2%

A poor result from Tabcorp (-8.4%) sent the shares sharply lower during the month, with increased costs in the wagering business (+2.9%) and opex growth (+4.1%) offsetting modest revenue growth (+2.6%). The company also unwound the cash-settled equity swap that referenced 117m Tabcorp shares, selling the shares at a 0.5% discount to the prevailing market price. We capitalised on the liquidity event, hedging the long position with a short in SkyCity Entertainment (-5.1%).

We unwound our paired position between toll-road owners Macquarie Atlas Roads (-3.5%) and Transurban (-3.7%), following a narrowing in the spread. Both companies reported during the period, with Macquarie Atlas confirming it continues to pursue the internalisation of management – a move, that if successful, may require a capital raise. Transurban reported a strong 1H18 results ahead of preparing to bid on the sale of the 51% stake in Westconnex in NSW.

We continued to increase our holding in QMS Media (+1.0%), hedging the position with a short in oOh! Media (+0.5%). While both Out-Of-Home advertising companies reported positive results during the month, QMS has superior EPS growth forecast, yet trades at a 4% discount to oOh! Media. There was also some speculation in the local press, suggesting QMS could be a takeover target and they have accordingly appointed an investment bank for defence.

A paired position between Investa Office (-4.5%) and Dexus (-2.4%) was established during February, with Investa at one stage trading at a 15.3% discount to NTA. Dexus also suffered in the month, with the stock trading at a modest discount to NTA for a brief period.

For the third time in the past year, we established a long in Fletcher Building (-15.0%), hedged with a short in Adelaide Brighton (+1.4%). During the month, Fletcher Building announced yet another earnings downgrade - the fifth in the past 14 months. Once again, the root of the downgrade was an increase to provisioning within the Building and Interiors division which continues to suffer cost overruns. Importantly, this was the first provision from the company since the new Managing Director has assumed control. The downgrades have led to a de-rating of Fletchers, with the company trading at an FY19 EV/EBITDA multiple of just 7.3x – if this is to be believed, it compares favourably with Adelaide Brighton which trades at 11.7x.

We also established a position in Suncorp Group (+1.8%) during February, after the company reported a result that missed consensus earnings expectations. Following the disappointing 1H18 results, margins were effectively re-set, with Suncorp providing guidance for 2H18 and FY19. Specifically, the company said that it expected a “stronger outlook for the second half, with favourable operating conditions expected to continue”. It also expected its strategic programs to support growth and deliver cost efficiencies. While some elements of the group’s strategy and guidance remain unclear and carry execution and hazard protection risk, we believe there is absolute and relative valuation appeal in Suncorp at our recent entry price. On consensus forecasts, Suncorp is forecast to deliver growth in earnings per share of over 20% in FY19 and 6% in FY20 and is supported by an attractive dividend yield of almost 6%, fully franked.

Special Situations – Gross Contribution -0.5%

Paragon Care (-2.7%) announced a capital raising in February, to fund the acquisition of three businesses – Insight Medical ($5m), Medtech Solutions ($2.4m) and Seqirus ImmunoHaemotology ($8.5m). Later in the month they also announced the acquisition of a 4th business – Surgical Specialties Group for $32.4m, a distributor of surgical medical devices to Australia and New Zealand. All of the acquisitions are accretive, and in line with the company’s strategy of expanding their existing footprint in both product and geography. We participated in the raising, adding to our existing holding at a modest discount to the prevailing share price.

We continued to add to our long position in Propertylink (-0.5%), with the stock trading down below NTA early in the month. With e-Shang Redwood (unlisted) and Centuria Capital (-3.2%) both on the register and accounting for approximately 38% of outstanding shares, we expect an approach from one or both will prove to be the catalyst for realising the position.

We sold our remaining holdings in Murray River Organics (-1.2%) and Yowie Group (-34.4%).

Sector Allocation

Sector	Long Equity	Short Equity	Net Equity
Banks	0.6%	0.0%	0.6%
Div Financials	0.0%	0.0%	0.0%
Insurance	1.3%	-0.7%	0.7%
Regional Banks	0.0%	0.0%	0.0%
REITs	52.0%	-38.7%	13.3%
Financials	53.9%	-39.3%	14.6%
Builders	2.0%	-2.4%	-0.4%
Consumer Disc	3.9%	-0.3%	3.6%
Consumer Staples	0.2%	-0.8%	-0.6%
Contractors	1.1%	0.0%	1.1%
Gaming	0.4%	0.0%	0.4%
General Industrials	2.2%	0.0%	2.2%
Health Care	5.3%	0.0%	5.3%
Information Technology	0.2%	0.0%	0.2%
Infrastructure	0.0%	0.0%	0.0%
Materials	1.0%	-1.0%	0.1%
Media	4.3%	-2.6%	1.7%
Telcos	0.0%	0.0%	0.0%
Utilities	3.4%	-1.6%	1.9%
Industrials	24.3%	-8.6%	15.7%
Bulk Metals	11.4%	-11.7%	-0.3%
Energy	0.1%	0.0%	0.1%
Gold	0.0%	0.0%	0.0%
Resources	11.5%	-11.7%	-0.2%
Hedge	0.0%	-5.6%	-5.6%
Index	0.0%	-5.6%	-5.6%
Total	**89.6%**	**-65.2%**	**24.5%**

Market Commentary

Global Market Overview

In February, volatility was back with a vengeance. Equity markets around the world ended the month in the red, with significant intra-month fluctuations. Early in the period, a sudden futures related technical sell-off hit global stock markets, amid concerns over rising inflation and rising interest rates. The VIX index, which measures volatility, saw the sharpest one-day spike in its history. The spike was exacerbated by the so-called “target volatility funds” that scrambled to sell stocks and buy VIX options. US equity markets led the weakness and the yield on US 10-year bonds hit a high of 2.95%. Inflationary concerns and stretched equity valuations weighed on investor sentiment. European and Asian markets were not spared and also ended the month in negative territory.

USA

After logging its strongest January since 1987, the S&P 500 index and the Dow Jones Industrial Average index ended February down 3.7% and -2.6% respectively. Considering the underlying fundamental strength of the US economy and better-than-forecast corporate profit reports, a number of several hundred point swings in the Dow Jones caught many investors unawares. Optimism over the effect of the Trump corporate tax cuts on earnings quickly gave way to concerns over rising inflation and interest rates. Some commentators believe that the fiscal stimulus from the tax cuts could be inflationary given the underlying strength of the economy and tight labour market. Towards the end of the month, the new Chairman of the Federal Reserve, Jerome Powell, provided a bullish assessment of the US economic outlook, but hinted clearly that the Fed could step up the pace of rate rises. This forced a rethink that perhaps the market was getting ahead of itself and was too sanguine on inflation and valuations. Four rate hikes are now expected by the Fed in 2018.

The US dollar was stronger against a basket of currencies, buoyed by the prospect of higher rates. Following Chairman Powell’s hawkish congressional testimony, the dollar index touched a five-week high, maintaining its upward momentum.

Early March saw Wall Street fail to gain ground as the prospects of inflation and interest rate rises, downward revisions to fourth-quarter US GDP, weaker Chinese PMI numbers and a likely trade war stifled positive sentiment.

Europe

European markets were sluggish across the board. The weakness in the US and similar fears about stronger inflation and higher rates pulled markets lower, with the UK’s FTSE 100 down 3.4%, Germany’s Dax down 5.7% and the French market down 2.9%. Politically, it was heartening that a deal was struck in Germany for a coalition government to be formed, ending the political limbo. The Bank of England left rates on hold and the European Central Bank President indicated that the true amount of economic slack “could slow down the emergence of price pressures”, putting Europe slightly at odds with the commentary from the US.

Asia

Asian markets followed the US markets’ lead and were weaker in all major jurisdictions. Of the larger bourses, Japan closed down 4.4%, Hong Kong was down 5.6%, India lost 5.0% and the Shanghai B index lost 4.9%. Korean stocks lost 6.2%, the worst monthly decline since June 2013. While global fears of a pickup in inflation and the possibility of stretched valuations were to blame for the weaker performances, a disappointing Chinese official manufacturing PMI print in February also contributed. Chinese PMI dipped to 50.3 from 51.3 in January and was much weaker than consensus expectations of 51.1. This was the lowest reading since July 2016 and was enough to dampen growth expectations.

Commodities

Commodity prices were generally weaker in February with oil going from being one of the best performing commodities in January to being one of the worst performing, ending the month down 4.8% to US$61.60 a barrel. Data released in February indicated that US oil production surged to an all-time high in November, with US producers pumping just over 10 million barrels a day. Gold fell 2% in February, after a volatile month's trading.

Bonds

The month was characterised by Treasury yields continuing to nudge higher, with the US 10-year bond yields hitting 2.95% intra-month, but failing to crack the 3% level. Debate rages on the extent of the bond market correction, but the market now expects the Fed to raise rates more aggressively than it did last month.

Australia

The Australian market performed better than its global peers. **The S&P/ASX 200 Accumulation Index ended February up 0.4%**. The market traded in a wide 300 hundred-point range as global equity markets corrected. Of the sub-sectors, the ASX Accumulation 200 Industrials Index took line honours with a return of 0.6% while the ASX Accumulation 200 Resources Index took out the wooden spoon returning -0.7%. The Small Ords Accumulation Index delivered a flat return.

First the correction then the recovery: The ASX 200 entered the FY18 interim results season overshadowed by a global equity market correction, with major global equity indices falling by as much as 8% (in USD terms) through this period (31 January to 8 February). Domestically, the ASX 200 found its low on 12 February and at this point the index had fallen 3.6% since the start of the month. From these lows, the ASX 200 gained 4.1%, to close the month at 6016 pts, 0.4% higher than it started.

Guidance leads to more upgrades than downgrades: 166 companies reported full-year and interim results through February, representing 75% of the ASX 200 by market cap, with 43% of companies' consensus EPS for FY18 revised higher compared to 34% revised lower for an up/downgrade ratio of 1.2x. More importantly, where guidance was given, it led to 1.5x more upgrades than downgrades for FY18 consensus EPS, with 44% of companies' consensus EPS revised higher versus 30% revised lower. Sectors which had the largest positive EPS revisions (on weighted average basis) were Energy, Industrials, Tech and Health Care, whilst sectors with negative EPS revisions include Telecommunications, Financials and Materials.

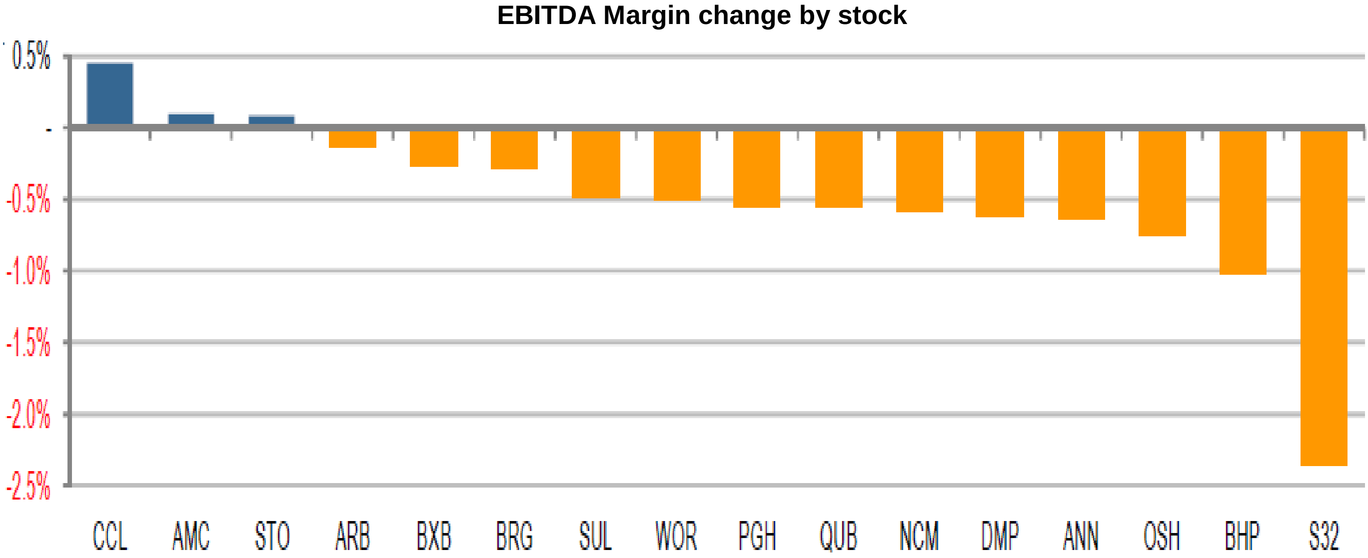
Upgrades rewarded: Companies with positive EPS revisions of greater than +1%, on average outperformed the ASX 200 by +2.3% on results day and continued to outperform post results announcement by +3.9%. Misses, however, were punished to the tune of -2.6% on results day and continued to retreat by 5.0% on average post results announcement.

With reasonable reported earnings growth and more companies than not reaffirming or slightly upgrading on full-year guidance, the "bottom up" consensus forecasts for the overall market were upgraded for FY18 and FY19. Following this reporting season in Australia, we would make the following observations:

- Results have on average been better than expectations, with the number of companies beating expectations exceeding the number of companies missing expectations.
- Companies are still returning cash to shareholders, with payout ratios edging higher, mostly due to upward surprises by resource companies and miners returning cash to shareholders at the expense of ramping up capex.

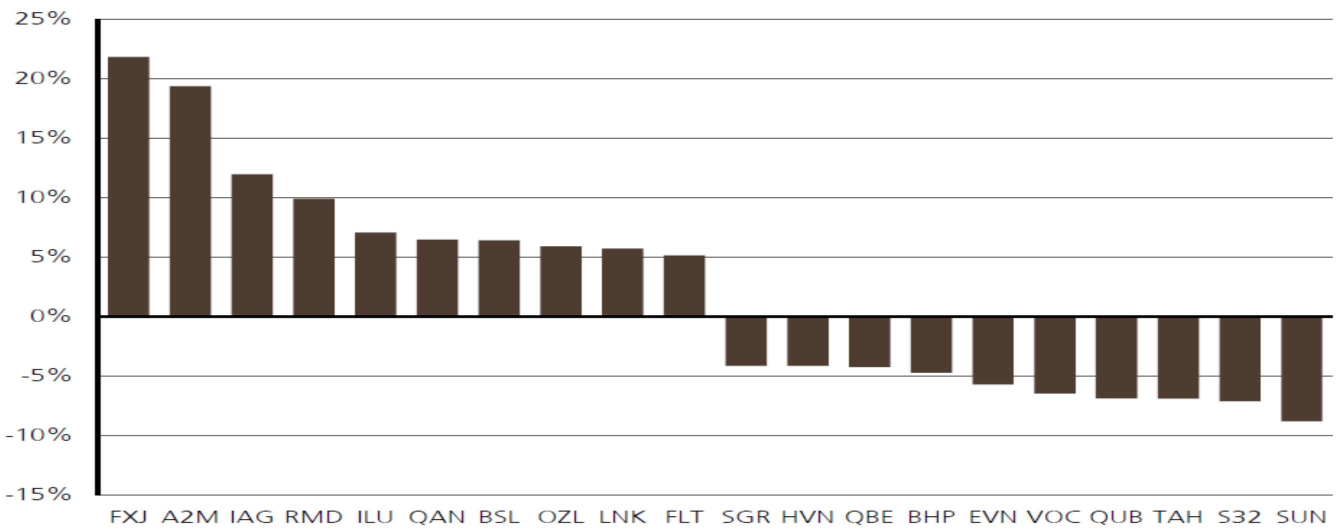
- Investors continue to reward high PE stocks, with growth and momentum stocks miraculously recouping most of their losses from the sell-off in early February, while value stocks lagged.
- Top-line growth expectations continue to be positive, but margin expectations have been trimmed partly because they were already high and some companies are reporting cost pressures.
- Cost pressures have started to materialise, especially in the Materials and Energy sectors.

See the chart below that sets out EBITDA margin forecast revisions for key companies that have pointed to higher costs.



Source: JP Morgan estimates, Bloomberg.

The chart below shows the 10 largest consensus EPS upgrades and downgrades in the ASX100.



Source: UBS, Factset.

The best performing sectors were Health Care (+7.0%, led by CSL which was up 11.4% and Primary Health Care up 9.9%), Consumer Staples (+1.1%, led by a2 Milk, up a staggering 47.5% after it upgraded earnings, and a strong rebound in performance from Graincorp, up 7.7%), and Information Technology (+0.9%, led once more by Altium, NEXTDC and Computershare after they all delivered solid results).

Rising bond yields hit interest rate sensitive sectors and weaker oil prices plagued the energy sector. Not surprisingly, the Telecommunication sector underperformed (-7.8%), led by Vocus Group down a whopping 18.1% after it cut its 2018 guidance, and Telstra down 8.7%, Energy (-4.6%), was dragged down by Woodside Petroleum slumping 10.9% after it announced its FY17 results, the acquisition of an additional 50% interest in Scarborough and an unexpected $2.5 billion equity raising, and Utilities (-2.9%). Financials also struggled, ending the month down 0.2%.

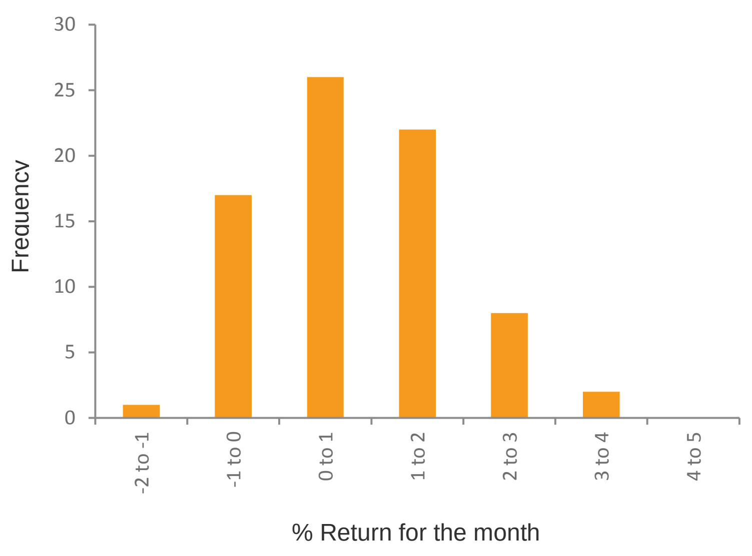
The stocks that added the most to the index in February were CSL (+26.5 points), National Australia Bank (+11.3 points), a2 Milk (+11.2 points), Insurance Australia (+10.3 points) and Australia and New Zealand Banking Group (+6.2 points). The main points detractors were Woodside Petroleum (-10.4 points), South 32 (-10.0 points), Wesfarmers (-6.3 points), Telstra Corporation (-6.3 points) and Commonwealth Bank (-4.5 points).

The Reserve Bank of Australia kept interest rates on hold in February, with the Governor warning that “one continuing source of uncertainty is the outlook for household consumption…household incomes are growing slowly and debt levels are high”.

Contribution

Relative Value Gross Contribution	1.2%	Special Situations Gross Contribution	-0.5%
Positive		**Positive**	
INGENIA COMMUNITIES GROUP - MIRVAC GROUP	0.16%	S&P/ASX 200 INDEX PUT OPTIONS	0.03%
AVEO GROUP - MIRVAC GROUP	0.13%	SUNCORP GROUP LTD	0.02%
AVEO GROUP - GPT GROUP	0.12%	CAPITOL HEALTH LTD	0.01%
BWP TRUST - PEET	0.11%	PRO-PAC PACKAGING LTD	0.01%
AUSTRALIAN UNITY INVESTMENT REAL ESTATE - GPT GROUP	0.11%	EMECO HOLDINGS LTD	0.01%
Negative		**Negative**	
RIO TINTO - RIO TINTO PLC	-0.37%	SUPERLOOP LIMITED	-0.16%
BHP BILLITON - BHP BILLITON PLC	-0.22%	NUFARM FINANCE NOTE	-0.10%
GOODMAN GROUP - GATEWAY LIFESTYLE	-0.10%	IMPEDIMED LTD	-0.08%
GROWTHPOINT PROPERTIES - GATEWAY LIFESTYLE	-0.09%	YOWIE GROUP LTD	-0.07%
CENTURIA METROPOLITAN REIT - GROWTHPOINT PROPERTIES	-0.06%	TURNERS AUTOMOTIVE GROUP LTD	-0.06%

Distribution of Net Returns



TOP RELATIVE VALUE POSITIONS

- RIO TINTO - RIO TINTO PLC
- BHP BILLITON - BHP BILLITON PLC
- CENTURIA METROPOLITAN REIT - GROWTHPOINT PROPERTIES
- AGL ENERGY LTD - INFIGEN ENERGY
- AVEO GROUP - GOODMAN GROUP
- ELANOR RETAIL PROPERTY FUND - SHOPPING CENTRES AUSTRALASIA
- GROWTHPOINT PROPERTIES - INGENIA COMMUNITIES GROUP
- GOODMAN GROUP - INGENIA COMMUNITIES GROUP
- AUSTRALIAN UNITY INVESTMENT REAL ESTATE - GPT GROUP
- ADELAIDE BRIGHTON - FLETCHER BUILDING

TOP SPECIAL SITUATION POSITIONS

- S&P/ASX 200 INDEX PUT OPTIONS
- NUFARM FINANCE NOTE
- IMPEDIMED LTD
- CARINDALE PROPERTY TRUST
- SUPERLOOP LIMITED
- PROPERTYLINK GROUP
- PRO-PAC PACKAGING LTD
- AUSTRALIA AND NEW ZEALAND BANKING
- PARAGON CARE LTD
- ONEVIEW HEALTHCARE PLC

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: $1.1898

Redemption price: $1.1838

Market Neutral Fund AUM: $629.10M

Australian Equity Team AUM: $3.54bn

Firm AUM: $5.77bn

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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