Ellerston Capital

Ellerston Australian Market Neutral Fund

PERFORMANCE REPORT May 2018

Fund performance^ (Net)

Net	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
2018	-0.03%	0.54%	-0.34%	-1.19%	-0.28%								-1.30%
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	-0.28%	0.13%	-0.41%	-0.27%	Positive months	72%
3 Months	-1.80%	0.37%	-2.17%	-2.04%	No. Relative Value positions	142
6 Months	0.81%	0.74%	0.07%	1.34%	No. Special Situations	37
1 Year	3.98%	1.49%	2.49 %	5.62%	Net Equity Exposure	+24.4%
2 Years p.a	3.57%	1.52%	2.06%	5.36%	Gross Portfolio Exposure	174.1%
3 Years p.a	4.86%	1.68%	3.19%	7.03%	Beta Adjusted	3.9%
Since inception p.a	8.92%	1.99%	6.93%	12.05%	Correlation Coefficient (vs ASX 200 Accum)	-9.08%
					Net Sharpe Ratio (RFR = RBA Cash)	1.83

Performance

The net return of the Fund in May was -0.3%, compared with the benchmark return of +0.1%. Despite the performance, the benefits of diversification were demonstrated in the period, with Special Situations adding 1.14%, while Relative Value detracted -1.41% (both gross returns).

Ellerston Capital Limited
ABN 34 110 397 674
AFSL 283 000

Level 11
179 Elizabeth Street
Sydney NSW 2000

Tel: 02 9021 7797
Fax: 02 9261 0528

info@ellerstoncapital.com
www.ellerstoncapital.com

APIR Code: ECL0013AU

The impact of passive investing is becoming more obvious in the Australian market. Despite the macro headwinds, large-cap REITs continued their recent outperformance in May, with the sector adding +3.1% compared with the broader market return of +1.1%. The catalyst behind the move appears to be the removal of Westfield from the index, forcing passive funds to rotate into the other constituents, regardless of share price. This has inflated the value of the larger property companies within the index to levels not seen since before the GFC.

The impact can be illustrated in the current pricing of Goodman Group (+3.0%), a well-managed property company focusing on industrial assets and with forecast growth of between 5 and 7% pa. Goodman currently trades on a PE ratio of 20.1x, 29% higher than its 5-year average PE of 15.6x. In comparison, the ASX200 trades on a PE of 16.3x, with a 5-year average of 16.0x and forecast growth of 7.5%.

Net exposure of the Fund was steady at +24.4% with a beta-adjusted net of +3.9. Gross exposure retreated, closing the month at 174.1%.

Our paired positions between Fletcher Building (+4.6%) and both Adelaide Brighton (+1.7%) and CSR Limited (-8.6%) added to performance during May, with Fletchers building on its recent rally, following the capital raise in April. During the month, Fletchers announced that it had agreed on a permanent solution to the breaches of financial covenants across its funding arrangements, with the agreed terms consistent with those that were targeted by the company. The company also appointed Macquarie Capital to sell its US-based Formica laminates business, an asset that has previously been identified as non-core.

Gateway Lifestyle (-9.5%) surprised the market in early May, when it downgraded its FY18 guidance with just two months of the financial year to go. The manufactured housing estate owner attributed the downgrade to fewer than expected home settlements, with guidance reduced to 230-240 settlements from 250 previously. Whilst the magnitude of the downgrade was modest, the market has lost confidence in management and the share price suffered accordingly. Our long position, hedged with Growthpoint Properties (+3.2%) and Goodman Group detracted from the value of the Fund.

Late in the month, the Singaporean sovereign-wealth fund GIC and a local JV partner announced that they had acquired National Lifestyle Villages – a WA-based portfolio of MHE communities. We expect this will be the start of industry consolidation within the sector and retain our long positions in both Gateway and Ingenia Communities (+0.4%) as part of a number of pairs.

The share price of land developer Peet Ltd (-6.7%) retreated during the month, underperforming the property sector and detracting from the value of the Fund. The only news on Peet in the period was positive – the company announced that it had agreements confirming its appointment as the WA Government’s development manager for a housing project in Brabham – 22 km from the Perth CBD. The development represents another “capital-light” project for Peet in that a new wholesale fund will be established, with a wholesale investor that will jointly develop the project alongside Peet.

Most Special Situations added value in the month with Infigen Energy (+8.0%), Sundance Energy (+11.3%) and Superloop (+23.7%) making the largest contributions. A raid on the register of Tilt Renewables (+8.8%) by Mercury (-0.3%) added to the recent interest in renewables, with the Infigen share price directly benefitting from the raid. A rising oil price helped buoy the share price of Sundance Energy, however the rally was a little muted given the market is still digesting the large capital raise held earlier in the year. Superloop held their maiden investor day during the period, with investors becoming more confident around the strategy, in particular the ability to commercialise their infrastructure.

Our long positions within the healthcare sector added value with Paragon Care (+10.5%), Capitol Health (+7.3%) and Oneview Healthcare (+5.4%) all closing higher in the period.

Our index put option protection modestly detracted from the performance of the Fund, with the Australian market closing the month higher.

Activity

Relative Value – Gross Contribution -1.41%

The Australian Government's 2018-19 Budget included an initiative forcing super funds to transfer to the ATO, small accounts that have not had a contribution in the last 13 months. While super account consolidation is not a new theme, it is clear the new proposal will have ramifications throughout the financial services sector, in particular on Link Group (-17.3%). Link is the leading provider of outsourced administration platform services to the Australian super fund industry, as well as providing shareholder services to Australian, New Zealand and international listed companies. While the proposed change took the market by surprise, the fact remains that Link is the lowest cost funds administration provider in Australia. We believe that the long-term growth story in Funds Administration remains intact, and that rising regulatory uncertainty should lead to increased demand for low-cost outsourcing over time. We capitalised on the dramatic fall in the share price and established a long position, hedging the exposure with a short in ASX Ltd (+3.4%), which trades at an eye-watering FY19 PE ratio of 24.2x.

CSR reported their FY18 result during May, with most divisions performing as expected. There was however, a surprise in the Aluminium division, with the company disclosing a much higher increase in realised energy prices. Whilst the market was across an expected $50m electricity cost hit, 2H18 included costs that implied closer to an $80m run rate. The disclosure spooked investors, with the stock trading down almost 4.5% on the day, on increased volume. We capitalised on the share price fall, unwinding our short CSR, long Fletcher Building pair.

We established a paired position between NZ energy generation-retailers, Meridian Energy (+1.5%) and Contact Energy (+7.1%) in May. Weakness in the Meridian share price surrounding the MSCI index rebalance (in which Mercury was removed) provided a good buying opportunity. Meridian has the largest hydro generation capacity in New Zealand, and has branched out into the Australian energy market under the Powershop brand. We are supportive of these expansion plans, in addition to the recent acquisition of five hydro power stations in Australia, which will leave the company with a long generation electricity book. The long position was hedged with a short position in Contact, which primarily generates hydro and geothermal power in the south island of New Zealand. The expected closure of the Wairakei A/B geothermal power station raises some concerns over the medium term, given the capex required to commission a third unit at the Te Mihi site.

Special Situations – Gross Contribution 1.14%

The merger of Westfield (-3.9%) and Unbail-Rodamco (-0.4%) closed at the end of May, with Westfield shareholders receiving shares in both Unibail-Rodamco and OneMarket (+0.7%) as well as cash. Our long position in Westfield was matched with a short in Unibail-Rodamco, and we also received shares in OneMarket, which remain in the portfolio. OneMarket's strategy is to develop a retail technology network that seeks to help bricks-and-mortar retailers compete more effectively. In developing the network, OneMarket is hoping to collate data around the shopping habits of consumers that can then be leveraged by both retailers and landlords. Whilst the business is only in its infancy, with a net cash balance of $200m and groups like Macerich, Taubman and Nordstrom onboard, we are optimistic about the company's prospects.

Sector Allocation

Sector	Long Equity	Short Equity	Net Equity
Banks	0.6%	0.0%	0.6%
Div Financials	2.3%	-2.3%	0.0%
Insurance	0.7%	0.0%	0.7%
Regional Banks	0.0%	0.0%	0.0%
REITs	56.7%	-51.4%	5.3%
Financials	60.2%	-53.7%	6.5%
Builders	3.1%	-3.0%	0.1%
Consumer Disc	4.2%	-0.2%	4.1%
Consumer Staples	1.4%	-1.1%	0.3%
Contractors	1.2%	0.0%	1.2%
Gaming	0.0%	0.0%	0.0%
General Industrials	1.9%	0.0%	1.9%
Health Care	4.4%	0.0%	4.4%
Information Technology	0.7%	0.0%	0.7%
Infrastructure	2.2%	-2.2%	0.0%
Materials	0.0%	0.0%	0.0%
Media	5.0%	-3.5%	1.5%
Telcos	0.0%	0.0%	0.0%
Utilities	4.1%	-0.4%	3.7%
Industrials	28.2%	-10.4%	17.8%
Bulk Metals	6.6%	-6.4%	0.2%
Energy	2.3%	0.0%	2.3%
Gold	0.0%	0.0%	0.0%
Resources	8.9%	-6.4%	2.5%
Hedge	0.0%	-2.3%	-2.3%
Index	0.0%	-2.3%	-2.3%
Total	97.3%	-72.9%	24.4%

Market Commentary

Market Overview

In May, global market performance was mixed, with weakness in Europe and parts of Asia offset by the strength in US equities. The resurfacing of political uncertainty in Europe, the unexpected cancellation of the summit by President Trump with North Korea's Kim, and the prospect of renewed trade wars rattled markets. Also, the US withdrawal from the Iran nuclear deal and the potential impact on global oil supply saw oil hit a near 4-year high in mid-May. In the US, despite mixed key economic data points, the US dollar rallied, with rekindled strength in the IT sector and a more positive outlook towards S&P earnings driving the US market higher. Australia was in positive territory, as commodities and oil were stronger, causing the resources index in particular to lift the market, while telecommunications and consumer staples traded lower.

USA

The S&P 500 Index and the Dow Jones Industrial Average Index ended May up 2.4% and 1.4% respectively, but the NASDAQ was the star performer, returning an impressive 5.5% for the month. The ongoing US-China trade dispute showed no signs of a resolution, but had some notable developments. China offered to buy more US goods, but fell short of meeting demands from the US of reducing its trade surplus by $200 billion. China also announced a cut in tariffs on passenger cars from 25% to 15% from 1 July. However, on 29 May, the White House announced that a final list of imports subject to a 25% tariff will be announced by 15 June. Separately, the US fired the opening shot in a trade war with three of its biggest trading partners by deciding to levy tariffs on imports of steel and aluminium from the EU, Canada and Mexico. The justification, on national security grounds, was met with incredulity by its long-term allies that are negatively impacted by this move. It is expected that the EU, Canada and Mexico will retaliate.

US 10-year bonds were sold down initially, with the yield hitting 3.1% on 17 May, the highest level since 2011. But 'risk off' towards the end of the month, driven by the political machinations in Italy and concerns over other Southern European countries, saw yields in Italy, Spain and Greece rise sharply, while US yields declined as investors once again sought the safety of US bonds. The US dollar continued to rise in May, with the Euro weaker on the back of political uncertainty in Italy (the 3rd biggest economy in the EU).

Europe

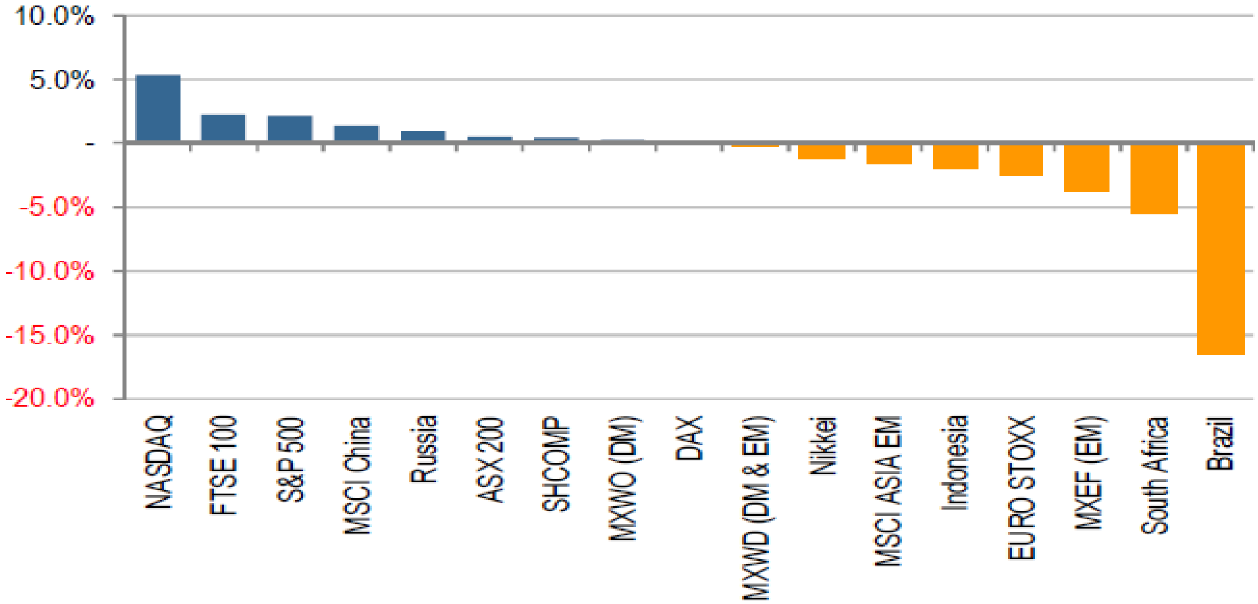
European stocks were generally weaker, with the Euro STOXX 50 Index declining 2.5%, France's CAC 40 returning -0.6% and Germany's DAX modestly in the red, returning -0.1%. Only the UK's FTSE 100 Index was in positive territory, up a healthy 2.8%, with the Bank of England voting to keep rates on hold at 0.5%. European stocks were buffeted by the political uncertainty in Italy, as investors digested the twists and turns in Italy's attempt to form a government. A proposed coalition between the anti-establishment Five Star Movement and the far-right League party fell apart as the President intervened to prevent the appointment of a Eurosceptic finance minister.

Asia

As trade talks between the US and China remained inconclusive, uncertainty in the Korean peninsula persisted and Malaysia elected a new government. Asian equities finished May weaker, with the Hang Seng ending the month down 0.4% and Japan's Nikkei 225 faring worse (-1.2%).

Emerging markets performed particularly poorly in May, with a higher US dollar and country-specific issues impacting markets. Brazil (down over 15%) and Turkey (down 3.6%) were notable underperformers. Developed markets outperformed emerging markets. See chart below:

Global Markets' Performance in May 2018



Source: JP Morgan, Bloomberg.

Commodities

Once again, bulk commodities were mixed, with iron ore down US$2/t while thermal and coking coal rallied in the period. Oil was the standout performer and closed higher (+US$2.42/bbl) fuelled by concerns over threats to global oil supply after the US withdrew from the Iran nuclear deal on 8 May. These fears were allayed towards month end as Saudi Arabia intimated that it could lift production to meet any shortfall, taking the steam out of the oil price which hit an intra-month high of US$80.50/bbl. As the US dollar firmed, given the flight to safety and weakness in the Euro, gold prices fell, and finished the month down 1.3%.

Bonds

US 10-year treasury yields briefly hit 3.1% on 17 May, the highest level since 2011, but investors soon sought the safety of US treasuries after they were spooked by the political ructions in Europe and yields were back below the 3% threshold, flattening the curve. In Australia, the curve also flattened, with the spread between long-term rates (10-year) and short-terms rates (3-year) narrowing.

Australia

The Australian equity market produced a month of positive returns with the S&P/ASX 200 Accumulation Index ending the period higher by 1.1%. The ASX 200 Resources Accumulation Index delivered another credible return of +2.6%, with the ASX 200 Industrial Accumulation Index rallying a more modest +0.7%. The Small Ordinaries Accumulation Index was the best performer, returning +3.7%.

Overall, May was volatile, marked by the release of the Federal Budget, the fallout from the Royal Commission and the geopolitical events mentioned previously. The latest round of the Royal Commission was less incendiary than the previous rounds and the big four banks delivered variable returns, with ANZ and Westpac delivering positive returns and

Commonwealth Bank and National Australia Bank delivering negative returns. Telecommunications were the worst performing sector (-10.2%), with Telstra being the main offender post a subdued outlook statement, while Healthcare (+5.6%) was the best performing sector supported by the continued strength in CSL, ResMed and Cochlear.

The top five stocks that contributed to the index were CSL (+26 points), BHP Billiton (+22 points), ANZ Banking Group (+12 points), Macquarie Group (+10 points) and Aristocrat Leisure (+8 points). The bottom five stocks that detracted from the index were Telstra Corporation (-17 points), Commonwealth Bank (-17 points), National Australia Bank (-12 points), Treasury Wine Estates (-7 points) and Brambles (-5 points).

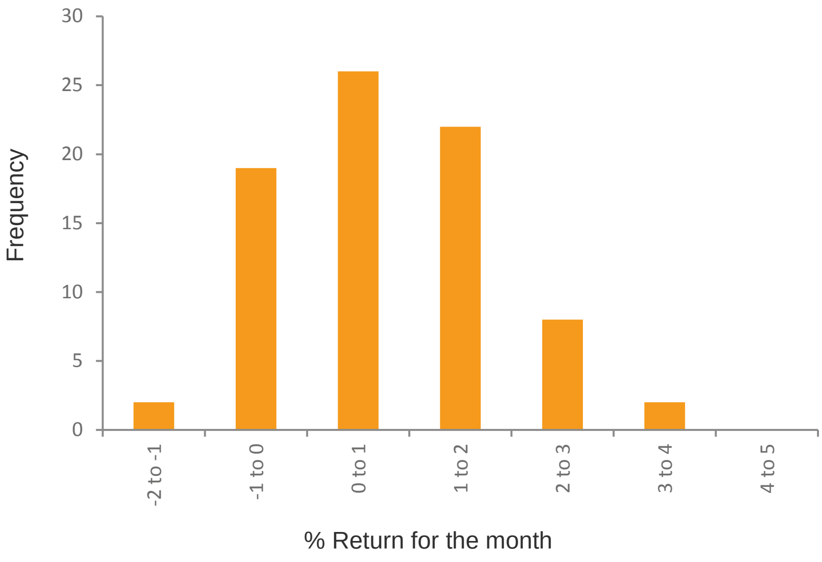
On 8 May, the Treasurer, Scott Morrison delivered the Federal Budget, which included a number of tax and spending measures that were funded by assumptions of improving economic prosperity. Hidden in the budget was an unexpected change to the administration of superannuation accounts, with the ATO to consolidate inactive accounts with balances of less than $6,000 that have had no activity for 13 months or more. This had a detrimental impact on Link Administration's share price (see more detailed write up above).

The Reserve Bank of Australia (RBA) chose to keep rates on hold again at 1.5% in May. The RBA reiterated its view on growth averaging a bit above 3% in 2018 and 2019. The Australian dollar depreciated against the US dollar, but appreciated in trade-weighted terms.

Contribution

Relative Value Gross Contribution	-1.41%	Special Situations Gross Contribution	1.14%
Positive		**Positive**	
ADELAIDE BRIGHTON - FLETCHER BUILDING	0.11%	SUPERLOOP LIMITED	0.35%
CSR - FLETCHER BUILDING	0.08%	INFIGEN ENERGY	0.23%
AGL ENERGY LTD - INFIGEN ENERGY	0.07%	SUNDANCE ENERGY AUSTRALIA LTD	0.23%
AUSTRALIAN UNITY INVESTMENT REAL ESTATE - NATIONAL STORAGE REIT	0.06%	PARAGON CARE LTD	0.11%
BWP TRUST - GDI PROPERTY GROUP	0.06%	GRAINCORP LTD	0.06%
Negative		**Negative**	
GROWTHPOINT PROPERTIES - GATEWAY LIFESTYLE	-0.24%	IMPEDIMED LTD	-0.09%
GOODMAN GROUP - GATEWAY LIFESTYLE	-0.23%	S&P/ASX 200 INDEX PUT OPTIONS	-0.08%
PEET - SHOPPING CENTRES AUSTRALASIA	-0.19%	MSL SOLUTIONS LTD	-0.03%
BWP TRUST - PEET	-0.17%	VITA GROUP LTD	-0.02%
CHARTER HALL RETAIL REIT - PEET	-0.13%	TURNERS AUTOMOTIVE GROUP LTD	-0.01%

Distribution of Net Returns



TOP RELATIVE VALUE POSITIONS

> RIO TINTO - RIO TINTO PLC
> ADELAIDE BRIGHTON - FLETCHER BUILDING
> AVEO GROUP - GOODMAN GROUP
> CENTURIA METROPOLITAN REIT - GROWTHPOINT PROPERTIES
> OOH!MEDIA - QMS MEDIA
> ELANOR RETAIL PROPERTY FUND - SHOPPING CENTRES AUSTRALASIA
> SYDNEY AIRPORT - TRANSURBAN GROUP
> GOODMAN GROUP - GATEWAY LIFESTYLE
> AVEO GROUP - DEXUS PROPERTY GROUP
> GROWTHPOINT PROPERTIES - INGENIA COMMUNITIES GROUP

TOP SPECIAL SITUATION POSITIONS

> INFIGEN ENERGY
> NUFARM FINANCE NZ LTD
> UNIBAIL-RODAMCO
> S&P/ASX 200 INDEX PUT OPTIONS
> SUNDANCE ENERGY AUSTRALIA LTD
> SUPERLOOP LIMITED
> IMPEDIMED LTD
> GRAINCORP LTD
> PRO-PAC PACKAGING LTD
> PARAGON CARE LTD

Key Information

Fund Inception Date: 3 June 2013

Liquidity: Daily

Management Fee: 1.20%

Performance Fee: 20% of outperformance

Buy/Sell Spread: 0.25%

Application price: $1.1686

Redemption price: $1.1628

Market Neutral Fund AUM: $620.6M

Australian Equity Team AUM: $4.1bn

Firm AUM: Over $6 billion

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.

Further Information

Contact:

Andrew Seddon 0417 249 577
aseddon@ellerstoncapital.com

Simon Glazier 0410 452 949

sglazier@ellerstoncapital.com