Ellerston Capital

Ellerston Australian Market Neutral Fund

Performance Report | September 18

FUND PERFORMANCE

%	1 Month	3 Months	6 Months	1 Year	3 Years p.a.	5 Years p.a.	Since Inception p.a.
Fund Net	-0.80	-4.52	-4.94	-1.87	2.25	7.14	7.62
RBA Cash Rate	0.11	0.37	0.75	1.50	1.61	1.91	1.96
Alpha	-0.91	-4.89	-5.69	-3.37	0.64	5.23	5.66

Source: Ellerston Capital Limited

%	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
2018	-0.03	0.54	-0.34	-1.19	-0.28	1.05	-2.78	-0.99	-0.80				-4.77
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. Past performance is not a reliable indication of future performance. The benchmark is the RBA Cash Rate.

Source: Ellerston Capital Limited

PORTFOLIO METRICS

Positive months	69%	Net Equity Exposure	+23.9%
No. Relative Value positions	85	Gross Portfolio Exposure	117.5%
No. Special Situations	34	Correlation Coefficient (vs ASX 200 Accum)	-7.81%
Beta Adjusted	-0.7%	Net Sharpe Ratio (RFR = RBA Cash)	1.39

PERFORMANCE

The Fund returned -0.8% in September, underperforming the benchmark return of +0.1% in the period. Relative Value (-0.6% gross) continued to struggle early but rebounded in the second half of the month. The contribution from Special Situations (-0.1% gross) was relatively flat, with the market remaining relatively complacent.

After a difficult period for our process, the environment seems to have normalised, with the rampant outperformance of stocks with momentum definitely showing signs of subsiding. That said, we continued to reduce our gross exposure, which closed the month at 117.5%. Net exposure at the end of September was +23.9% with a beta-adjusted net of -0.7%.

Investment Objective

The Fund targets Absolute Returns with an annualised return objective of 5% above the RBA Cash Rate over rolling five year periods.

Investment Strategy

The Fund will seek to provide investors with a return profile that has low correlation with traditional asset classes. The fund aims to generate positive returns in all market environment by reducing the majority of market risk and focusing on capital preservation and alpha generation. The Fund will utilise a Relative Value and a Special Situations strategy.

Key Information

Strategy Inception Date	3 June 2013
Fund Net Asset Value	$553.3M
Liquidity	Daily
Application Price	$1.0591
Redemption Price	$1.0538
Management Fee	1.20%
Buy/Sell Spread	0.25%
Performance Fee	20% of outperformance
Firm AUM	Over $5 billion

Our paired position between Fletcher Building (+2.4%) and Adelaide Brighton (-2.0%) once again added value, with Adelaide Brighton continuing to underperform following its FY18 results. Since reporting in August, a number of sell-side analysts have downgraded their Adelaide Brighton recommendations with headwinds including rising energy costs and a slowing housing cycle regularly cited. To make matters worse, both the highly-regarded CEO and CFO have recently resigned, with the CEO announcing that he would be joining the board of Fletcher Building.

A modest rebound in the share price of QMS Media (+2.2%), coupled with a fall in oOh!media (-2.3%), led to the paired position adding to the performance of the Fund in the month. Despite a narrowing in the spread, QMS Media continues to screen incredibly cheap when compared with oOh!media, with EV/EBITDA multiples of 8.2x and 10.2x respectively.

Despite having very little exposure to aged care, retirement village operator Aveo (-14.0%) was caught up in the Prime Minister's recent announcement of a Royal Commission into Aged Care. While the company fared better than the actual listed aged care providers (average fall of 18.5% in the month), the impact was substantial, with the stock underperforming all of its Real Estate peers. At a P/E ratio of 10.0x and a P/NTA of just 0.51, the company looks incredibly cheap, however we fear the increased publicity over the next 12 months will limit the scope for a re-rating and have consequently reduced our exposure.

The price of Nufarm hybrid securities (+4.3%) rebounded in September, adding value to the performance of the Fund. The catalyst was a $303m equity raise by Nufarm, which strengthened the balance sheet and hence improved the credit.

The performance of Infigen Energy (-5.6%) continues to frustrate us, with the share price move in September seemingly at odds with the fundamentals. Infigen has recently refinanced their debt, has a considerable development pipeline, and has its only Australian-listed peer (Tilt Renewables) currently under takeover. Yet the stock trades at a FY19 P/E of just 12.9x, despite having Brookfield Renewables recently emerge as a significant shareholder. The outlook for Infigen's electricity production in FY19 is underpinned by the Bodangora wind farm (14% increase) which is currently undergoing final commissioning and will be completed by year end. In addition, the recent rise in electricity futures contracts for the peak demand summer period (now at 135 $/MW in Victoria) will further support FY19 revenues.

After falling for no apparent reason in August, Oneview Healthcare (+33.3%) rallied for no apparent reason during September, with the performance contribution the largest within Special Situations.

ACTIVITY

Relative Value – Gross Contribution -0.64%

We established and unwound a paired position between Transurban (-5.5%) and Sydney Airport (-4.4%) in the month, capitalising on a short-term increase in the supply of Transurban scrip. At the end of August, Transurban announced the acquisition of a 50% equity stake in WestConnex, funded by a $4.2b equity raise. The raise was in the form of a renounceable entitlement offer, with the entitlement rights trading over the five days to September 11. We purchased both the rights and ordinary shares during the five day period, hedging the position with a short in Sydney Airport. By the end of the month, the spread between the two stocks had narrowed, and we were able to unwind our position for a modest profit.

A paired positions between mall-owners Scentre (-3.4%) and Vicinity (-5.4%) was established in September, during a period in which the spread between the two stocks became unsustainably wide. While both companies currently trade at a >10% discount to NTA, the Scentre portfolio is higher quality, and we argue, should trade at a premium to Vicinity. That said, Vicinity is in the midst of a sales process that when complete, should result in the quality of the two portfolios being more comparable. By the end of the month, the spread had narrowed and the position had been unwound.

We reduced both the Rio Tinto (+8.3%) and BHP Billiton (+7.2%) Ltd-Plc spread trades during the month, with a strengthening GBP helping to narrow the spreads.

Special Situations – Gross Contribution -0.05%

We added to our holding in IVE Group (-1.6%) in September, following a meeting with the printing company's management. Over the past 24 months, the printing industry has consolidated from five players to two, and IVE has emerged as the lower-cost operator, with recent bolt-on acquisitions added to their product offering. While management has consistently proven their ability to acquire and integrate businesses, for the first time in a number of years, there are no acquisitions on the horizon. More importantly, they feel that their product offering is finally complete and they can now focus on organic growth – for the first time since listing in 2015. Trading at a FY19 P/E of just 8.0x and a fully-franked dividend yield of 7.2%, we capitalised on a liquidity event and added to the position.

We covered our short position in Propertylink (+4.2%) and went long in what was an incredibly busy period for mid-cap, industrial-focused REITs. In mid-September, Propertylink conducted a raid on the register of Centuria Industrial REIT (+4.9%), acquiring almost 18% of the issued securities, at an eye-watering 16.8% above the 30 June NTA. They promptly announced a full takeover, offering Propertylink scrip for the remaining stock on issue. Centuria Capital (-1.4%) then returned fire, increasing their stake in Centuria Industrial to 23% under the creep provision and also adding to their stake in Propertylink. Centuria Capital then announced their intent to requisition a meeting of Propertylink shareholders to replace the board. Later in the month, ESR Real Estate submitted a non-binding, indicative proposal to acquire all of the securities in Propertylink at a price of $1.15 per security. We expect that the ESR proposal will succeed, with Propertylink shareholders ultimately benefiting from their board's apparent recklessness with shareholder's funds.

It was a busy month for equity placements, with the Fund participating in raisings for Syrah Resources (-9.4%), Northern Star Resources (+20.0%), Nearmap (+4.9%) and Bega Cheese (-12.4%).

We sold out of our remaining holdings in Acrow Formwork and Construction (+14.8%) and Healthscope (-2.5%).

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	0.2%	0.0%	0.2%
Regional Banks	0.0%	0.0%	0.0%
REITs	40.9%	-33.5%	7.4%
Financials	41.7%	-33.5%	8.2%
Builders	1.8%	-1.0%	0.8%
Consumer Disc	2.4%	-0.2%	2.3%
Consumer Staples	0.5%	-0.5%	0.0%
Contractors	1.1%	0.0%	1.1%
Gaming	0.0%	0.0%	0.0%
General Industrials	2.0%	0.0%	2.0%
Health Care	3.5%	0.0%	3.5%
Information Technology	1.7%	0.0%	1.7%
Infrastructure	0.0%	0.0%	0.0%
Materials	0.0%	0.0%	0.0%
Media	4.0%	-1.7%	2.3%
Telcos	0.0%	0.0%	0.0%
Utilities	3.9%	0.0%	3.9%
Industrials	21.0%	-3.4%	17.6%
Bulk Metals	4.9%	-4.9%	-0.1%
Energy	0.4%	0.0%	0.4%
Gold	0.0%	0.0%	0.0%
Resources	5.3%	-4.9%	0.3%
Hedge	0.0%	-2.3%	-2.3%
Index	0.0%	-2.3%	-2.3%
Total	67.9%	-44.0%	23.9%

Source: Ellerston Capital Limited

MARKET COMMENTARY

Market Overview

Developed markets once again outperformed emerging markets in September, led by the US market, with the S&P 500 Index reaching a record high on 20 September. European markets were mixed, but finished modestly in the green overall. Australia was the worst performer amongst the developed markets. The Royal Commission into financial services released its interim report and it was grim reading for the major banks in particular. While the commissioner provided no recommendations at this interim stage, he was scathing in his assessment of the banks' unconscionable behaviour. Asia, led by Japan (+6.0%), was also in the green with the exception of the Indian stock market. Trade jitters continued to dominate news flow as President Trump announced further tariffs on Chinese imports towards the end of the month and China responded with retaliatory tariffs within 24 hours.

USA

The S&P 500 Index and the Dow Jones Industrial Average Index ended September up 0.6% and 2.0%, respectively. The tech-heavy NASDAQ ended the month down 0.7% after being up almost 6% in August. Investors generally ignored the noise around trade wars and focused on the stronger US economy and earnings prospects. That said, the technology sector was weaker, as it is more likely to be impacted by the trade wars and valuations are looking stretched to say the least.

Trade wars were in the headlines again, with the US announcing 10% tariffs on an additional $200 billion of Chinese imports effective 24 September and an increase in tariffs to 25% from 1 January 2019. China responded with retaliatory tariffs of between 5% and 10% on $60 billion of US imports within 24 hours. Despite investor's hopes, the probability of a short-term resolution to the trade war appears to be low.

During the month, as expected, the Federal Reserve increased its funds rate target range by 25 basis points to 2.0-2.25%. Hawkish commentary by Fed Chair Powell that accompanied that increase saw the US dollar experience a late surge to end the month flat.

The US economy keeps motoring along strongly. Activity indicators in August were robust. The manufacturing ISM bounced unexpectedly to 61.3 (previously 58.1) and the composite non-manufacturing ISM rose more than expected to 58.5 (previously 55.7). The unemployment rate held steady at 3.9% and this was modestly ahead of consensus expectations of 3.8%.

Europe

European equity markets were generally positive in September with the Euro STOXX 50 Index closing up 0.3%, as activity indicators softened. The Euro area composite PMI fell 0.3 points to 54.2 in September. In terms of the major indices, France's CAC 40 was up 1.7%, the UK's FTSE 100 was up 1.2%, but Germany's DAX was down -1.0% despite economic data prints tilted to the positive side, with Germany's unemployment rate hitting the lowest level since reunification in 1990.

Brexit battles continued with seemingly no progress on the negotiations between the UK and the European Union ahead of the next meeting in late October. The European Central Bank kept rates unchanged in September as its view on the risks to growth were "broadly balanced".

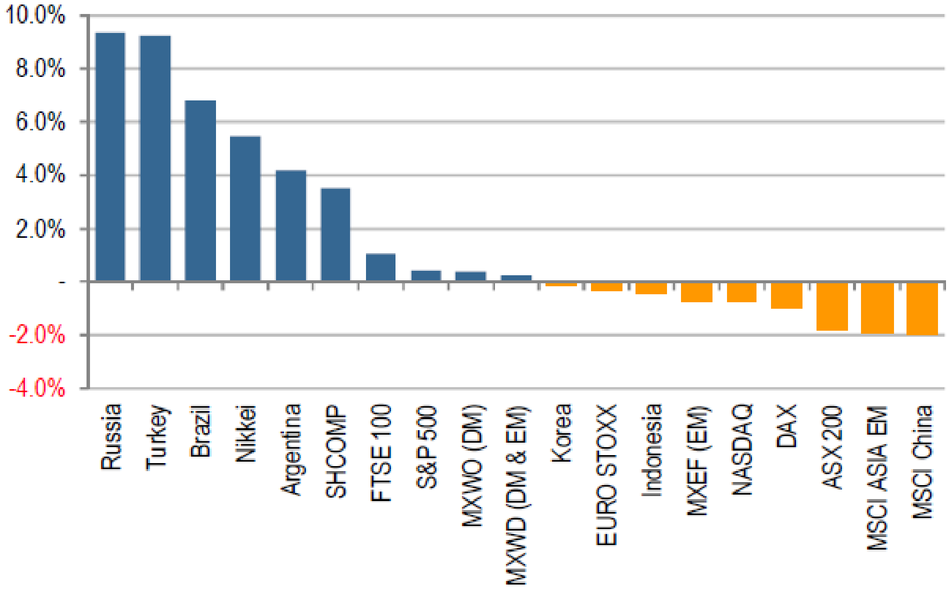
Asia

Despite US and China trade tensions simmering in the background, equity markets in Asia posted gains as investors focused on continued strong global growth. The Hang Seng Index was only modestly positive with a return of +0.1% but Chinese equities, badly hit last month and calendar year to date, rebounded. The SSE Total Market Index was up 3.8%. Japanese equities were also very strong with the Nikkei 225 index surging 6.0% post Shinzo Abe being re-elected as Prime Minister with markets taking comfort in his "Abenomics" strategy continuing.

While the Chinese announced retaliatory tariffs on $60 billion of US imports from 24 September, August exports moderated while imports held up. In September, the Chinese also announced targeted stimulus measures for its domestic economy to mitigate any likely adverse impact from the trade war with the US.

The threat to global growth and markets from a full blown trade war remains a real risk as we have highlighted previously.

Global Markets' Performance in September 2018



Source: JP Morgan, Bloomberg.

Commodities

After being down for three consecutive months, metals rebounded in September with the LME Metals Index up 2.3%. Zinc recorded the largest gain, up 8.0%, followed by Copper, +5.0%, however Aluminium declined 2.5%. Coking coal prices rose 9.2%, after two consecutive months of decline. Brent and WTI rose sharply in the month, with Brent up 6.9% to US$82.8 a barrel and WTI up 5.6% to US$73.30 a barrel. A very tight supply situation post US sanctions on Iran exports, coupled with demand growth of 1.6% helped fuel the rally in crude. Iron Ore was also strong up 4.6% to US$69.2 a tonne. Gold fell modestly, down 0.7% to US$1,193/oz. as the US dollar remained resilient.

Bonds

The US yield curve steepened with the 10-year bond yield rising to 3.06% and the 2-year bond yield up to 2.82% - the spread between long-term rates and short-term rates widened during the month. Continued emerging market fears and the Fed's more hawkish commentary on the direction of rates pushed the long end higher.

The Australian curve also steepened, with the spread between the long-term rates and short-term rates widening by 7.5 basis points during the month. The Australian 10-year bond yield finished 14.9 basis points higher to 2.67% following the US lead.

Australia

The S&P/ASX 200 Accumulation Index closed the month down 1.3%, dragged down by the Health Care and Financials sectors. The ASX 200 Resources Accumulation Index rebounded sharply, up 5.4%, with South32 rallying 15.3% and leading the charge. The ASX 200 Industrial Accumulation Index underperformed, falling 2.8%, while the Small Ordinaries Accumulation Index delivered modestly negative returns of -0.4%.

The market took some comfort from solid second quarter GDP data, with growth up 0.9% quarter-on-quarter, which saw the year-on-year growth rate register an above trend 3.4%. Employment in August was strong again, with the unemployment rate steady at 5.3% as expected. But July retail sales data was flat given subdued consumer discretionary conditions.

The best performing sector in September was Energy (+4.3%), led by Woodside Petroleum (+4.6%) and Origin Energy (+3.9%) as Brent and gas prices rallied on tight global supply. Materials was the next best performer (+4.2%) led by heavyweights BHP Billiton (+7.2%), South32 (+15.3%) and Rio Tinto (+8.3%) - all boosted by the rally in commodity prices and reversing some of last month's negative returns. The worst performing sector was Health Care (-7.8%) and it was also the most significant negative contributor to the market as a whole. The Health Care sector was dragged down by sector stalwart and highly-rated CSL

(-11%) and the announcement of a Royal Commission into aged care which also weighed heavily on the sector. Stocks in this segment such as Estia Health (-20.2%) were pulverised. The market was also led lower by the Financials sector (-2.2%) as the major banks (with the exception of Commonwealth Bank) were all in the red in anticipation of the Royal Commission's interim report.

The top five stocks that contributed to the index's return were BHP Billiton (+45 points), South32 (+17 points), Woodside Petroleum (+10 points), Telstra Corporation (+7 points) and Santos (+5 points). The bottom five stocks that detracted from the index's overall return were CSL (-68 points), Australia and New Zealand Banking Group (-23 points), Westpac Banking Group (-12 points), Aristocrat Leisure (-12 points) and Wesfarmers (-11 points).

The Reserve Bank of Australia chose to keep the cash rate unchanged at 1.5% again in September. Its accompanying statement was rather upbeat and guidance remained unchanged. As mentioned, the unemployment rate remained steady at 5.3%, even as the participation rate lifted modestly to 65.7%.

In trade weighted terms, the Australian dollar was flat but was appreciated 0.5% against the US dollar to end the month at 0.7218.

CONTRIBUTION

Relative Value Gross Contribution	-0.64%		
Positive		**Negative**	
ADELAIDE BRIGHTON - FLETCHER BUILDING	0.13%	AVEO GROUP - DEXUS PROPERTY GROUP	-0.32%
ARDENT LEISURE GROUP - VILLAGE ROADSHOW	0.13%	AVEO GROUP - GOODMAN GROUP	-0.25%
OOH!MEDIA - QMS MEDIA	0.13%	AVEO GROUP - SHOPPING CENTRES AUSTRALASIA	-0.13%
CENTURIA METROPOLITAN REIT - GOODMAN GROUP	0.07%	GROWTHPOINT PROPERTIES - INGENIA COMMUNITIES GROUP	-0.10%
BWP TRUST - CENTURIA CAPITAL	0.04%	AVEO GROUP - CENTURIA INDUSTRIAL REIT	-0.08%
Special Situations Gross Contribution	**-0.05%**		
Positive		**Negative**	
ONEVIEW HEALTHCARE PLC	0.19%	INFIGEN ENERGY	-0.21%
NUFARM FINANCE NZ LTD	0.15%	IMPEDIMED LTD	-0.08%
NORTHERN STAR RESOURCES LTD	0.05%	CATAPULT GROUP INTERNATIONAL	-0.06%
CAPITOL HEALTH LTD	0.04%	PRO-PAC PACKAGING LTD	-0.05%
ONEMARKET LTD	0.02%	JOHNS LYNG GROUP LTD	-0.04%

Source: Ellerston Capital Limited

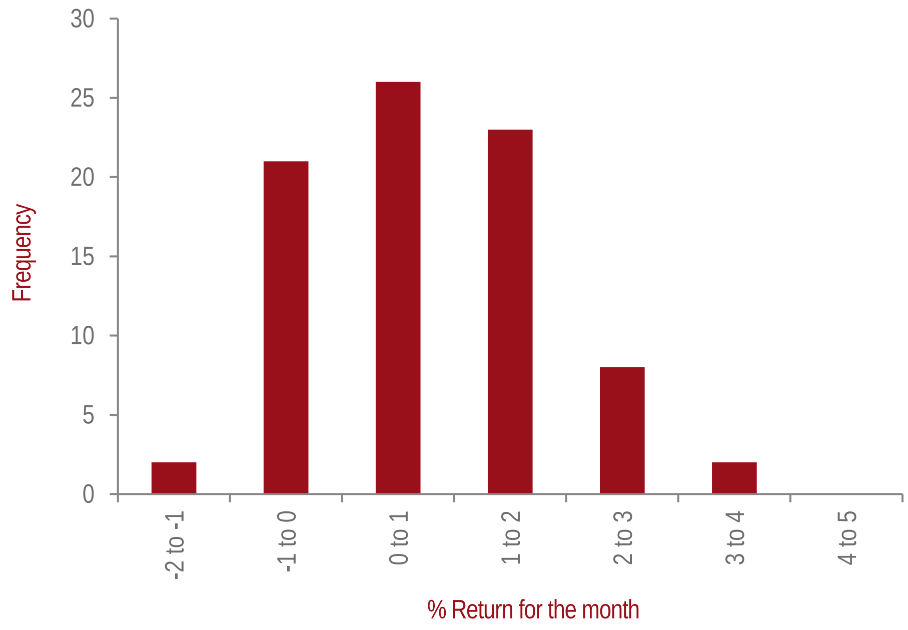
TOP 10 RELATIVE VALUE POSITIONS

- GROWTHPOINT PROPERTIES - INGENIA COMMUNITIES GROUP
- BHP BILLITON - BHP BILLITON PLC
- CENTURIA METROPOLITAN REIT - GROWTHPOINT PROPERTIES
- BWP TRUST - PEET
- CENTURIA CAPITAL - DEXUS PROPERTY GROUP
- OOH!MEDIA - QMS MEDIA
- RIO TINTO - RIO TINTO
- ELANOR RETAIL PROPERTY FUND - SHOPPING CENTRES AUSTRALASIA
- GPT GROUP - INGENIA COMMUNITIES GROUP
- CHARTER HALL RETAIL REIT - INGENIA COMMUNITIES GROUP

TOP 10 SPECIAL SITUATION POSITIONS

- INFIGEN ENERGY
- NUFARM FINANCE NZ LTD
- AUSTRALIAN UNITY OFFICE - RESTRICTED
- S&P/ASX 200 INDEX PUT OPTIONS
- AUSTRALIAN UNITY OFFICE FUND
- SUPERLOOP LIMITED
- IMPEDIMED LTD
- IVE GROUP LTD
- PRO-PAC PACKAGING LTD
- ONEMARKET LTD

DISTRIBUTION OF NET RETURNS



Source: Ellerston Capital Limited

Key Service Providers

Registry: Link Market Services Limited

Auditor: Ernst & Young

Prime Broker & Derivative Counterparty:

Morgan Stanley Intl & Co PLC

Goldman Sachs International

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. Goldman Sachs International has been added as a second Prime Broker during the month. Other than this addition there have been no changes to the key service providers described above.

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