

Ellerston Global Equity Managers Fund (GEMS)

Performance Report | October 18

PERFORMANCE SUMMARY

	1 Month	3 Months	1 Yr p.a.	3 Yr p.a.	5 Yr p.a.	Strategy Since Inception p.a.
GEMS A Net	-5.43	-9.22	-1.02	7.79	12.90	12.47
GEMS B Net	-5.43	-9.22	-1.02	7.78	12.77	12.30

Past performance is not a reliable indicator of future performance.

MARKET COMMENTARY

Market Overview

Equity markets around the world tumbled in October. Both developed and emerging markets were hit hard by a wave of selling, as fears about slowing global growth, trade wars and higher interest rates gripped investors. As the US 10-year bond yields backed up to over 3.2% for the first time since 2011, US and Australian equity markets sank as sky-high valuations for some growth stocks were brought back into sharp focus. Continuing and deepening trade disagreements between the US and China, the setback in Brexit negotiations between the EU and the UK over the Irish border, and the US threatening Iran with sanctions had investors adopting a “risk off” approach to their investments. Growth and technology stocks bore the brunt of investors taking flight.

USA

The S&P 500 Index and the Dow Jones Industrial Average Index ended October down 6.8% and 8.4%, respectively. The tech-heavy NASDAQ suffered an even greater fall and ended the month down 9.2%. While in September, investors generally ignored the noise around trade wars and focused squarely on the stronger US economy and optimistic earnings prospects, in October, high valuations and growth fears weighed heavily on sentiment.

Despite US GDP increasing 3.5% in the third quarter, US equities slumped the most since the sell-off in February, as some investors worried that US economic and profit growth may have peaked. The sharp rise in US 10-year bond yields acted as a key trigger for the sell-off in equities, with the Fed showing no inclination to slow or halt its tightening monetary policy stance. The impact of a trade war with China and geopolitical risks also contributed to negative sentiment, but alarming profit warnings from industrial bellwethers like 3M and Caterpillar spooked investors. Amazon also weighed on sentiment as the company guided to fourth quarter revenues that might miss consensus expectations. Technology stocks in particular were sold down, with Amazon and Netflix both losing around one-fifth of their market capitalisation.

In terms of the underlying economy, activity indicators were modestly stronger as Industrial production increased 0.3% in September, while manufacturing output increased 0.2%. The unemployment rate dropped from 3.9% to 3.7%, the lowest since December 1969, with labour force participation unchanged at 62.7%.

Europe

European equity markets were also sold down aggressively. The Euro STOXX 50 Index closed down 5.9% and is now down 9.1% over the past three months. The Euro composite PMI fell sharply from 54.1 in September to 52.7 in October. Brexit battles and the EU arguing with Italy over its budget imbroglio were European specific issues that added to negative global sentiment on growth and geopolitical uncertainty in October.

The UK’s FTSE 100 was down 4.9% (impacted by a further hiccup in the Brexit negotiations), but Germany’s DAX and France’s CAC 40 delivered even worse returns of -6.5% and -7.2% respectively.

Investment Objective

The investment objective is to generate superior returns for Unitholders with a focus on risk and capital preservation.

Investment Strategy

- > Global long/short equity
- > Overlays fundamental stock selection with macroeconomic outlook
- > Bias towards Australia

Key Information

Strategy Inception Date	1 January 2002
Fund Net Asset Value	A\$168.8
Liquidity	Quarterly
Class A Redemption Price	A\$ 1.3776
Class B Redemption Price	A\$1.3447
No. Stocks	115
Gross Exposure	145%
Net Exposure	78%
Management Fee	1.50% p.a.
Buy/Sell Spread	0.25%
Performance Fee	16.50%
Firm AUM	Over A\$5b

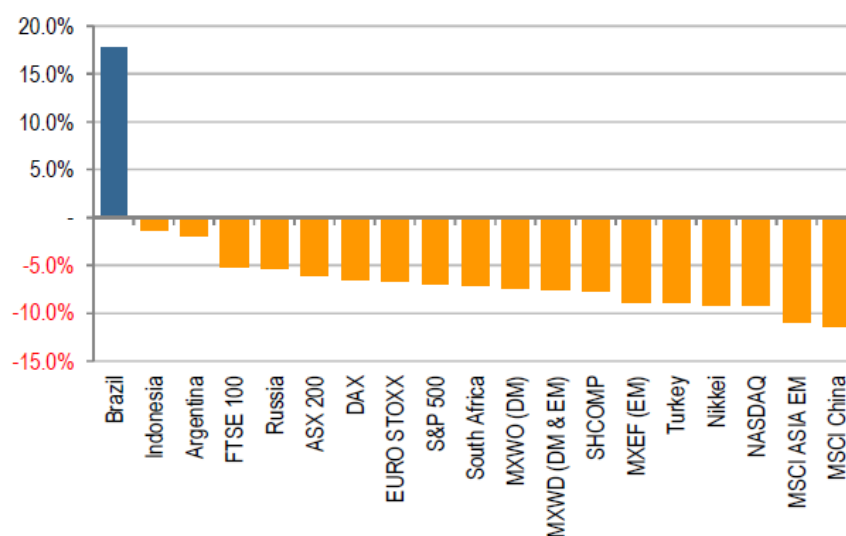
The European Central Bank kept rates unchanged in October as its view on the risks to growth were still described as “broadly balanced”.

Asia

All indices in Asia saw sharp sell-offs in early October, but modest rebounds late in the month. As investors feared a reversal of synchronised global growth and with US and China trade tensions simmering in the background, equity markets in Asia posted substantial losses. The Hang Seng Index returned -10.0% and Japanese stocks also underperformed, with the Nikkei 225 returning -9.1% (even after the Bank of Japan left monetary policy unchanged). The worst performer was the Korean market, with the KOSPI Composite Index delivering a shocking return of -13.4% on the back of soft GDP data and concerns over growth in its key auto industry. In China, the PBoC’s plan to give substantial credit support to private debt issuances failed to stem investor worries and the SEE Total Market Index was down 8.1%.

The threat to global growth and equity markets from a full blown trade war, coupled with tighter monetary policy impacting valuations, remain legitimate risks as we have highlighted previously.

Global Equity Markets’ Performance in October 2018



Source: JP Morgan, Bloomberg.

Commodities

After being down for three consecutive months, metals bounced in September, but the rebound was short lived. Metals fell again in October, with the LME Metals Index down 4.6%. Tin (+1.5%) was the only metal to record a gain in the month. Nickel declined 8.6%, while Lead (-6.1%), Aluminium (-5.5%), Zinc (-4.0%) and Copper (-3.6%) also finished in the red. Brent and WTI also fell sharply, down 8.8% to US\$75.04 and 1.6% to US\$ 65.31 a barrel respectively. Amidst all the fear, Gold prices modestly rose (+1.9%) as investors again flocked to its safe-haven status. Much to everyone’s surprise, the iron ore price also rallied (+9.4%), to finish the month at US\$75.65 a ton.

Bonds

The US yield curve steepened with the 10-year bond yield rising to over 3.20% mid-month and closing the period at 3.14%. The US 2-year bond yield rose a further 5 basis points to 2.87% - with the spread between long-term rates and short-term rates continuing to widen during the month. At this stage, the Fed remains committed to raising interest rates.

The Australian curve also steepened, with the spread between the long-term rates and short-term rates widening by 1.4 basis points during the month. The Australian 10-year bond yield finished 4.1 basis points higher at 2.63%.

Australia

The **S&P/ASX 200 Accumulation Index closed the month down 6.1%**. This was the worst month since August 2015 (when the market was down 8.6%) and it was the worst October in 10 years, when in 2008, the market was down 12.6%. All sectors were in the red, but the Financials, Materials and Energy sectors weighed particularly heavily on the index return in the month.

The ASX 200 Resources Accumulation Index was the worst performer, down 6.6%, with BHP Billiton (-7.0%) contributing most to the underperformance. The ASX 200 Industrial Accumulation Index fell 5.9%, while the Small Ordinaries Accumulation Index took the wooden spoon and underperformed the broader market, returning -9.6%.

The Financials sector delivered a total return of -5.9% - the major banks once again featured prominently with National Australia Bank (-9.4%) and Australia and New Zealand Banking Group (-8.0%) contributing most to the sector's poor performance. As mentioned, the Materials sector (-5.2%) was also a poor performer (-5.2%) with sector heavyweights BHP Billiton (-7.0%) and South32 (-7.7%) doing most of the damage. Energy delivered a return of -10.5% in October, with Woodside Petroleum (-9.7%), hurt by the fall in oil prices. Information Technology also had a dreadful month returning -11.2%, with "market darlings" Afterpay Touch (-30.4%) and Wisetech Global (-27.3%) quickly falling out of favour.

The top five stocks that contributed most negatively to the index's return were BHP Billiton (-47 points), National Australia Bank (-42 points), Australia and New Zealand Banking Group (-38 points), CSL (-33 points) and Wesfarmers (-22 points). The top five stocks that contributed positively to the index's return were Newcrest Mining (+6 points), Woolworths Group (+3 points), Evolution Mining (+3 points), Saracen Mining Holdings (+3 points) and Transurban Group (+2 points).

The Reserve Bank of Australia, not surprisingly, kept the cash rate unchanged at 1.5% again in October. Its accompanying statement noted that the unemployment rate was "trending lower" and that "the latest national accounts confirmed that the Australian economy grew strongly over the past year, with GDP increasing by 3.4 per cent".

In trade weighted terms, the Australian dollar depreciated 0.5% and 2.1% against the US dollar to end the month at 0.71.

Outlook and Portfolio Commentary

On the back of the equity market sell-off, we have done some selective buying, however, our overall strategy and our outlook have not changed materially. Our concerns over rising rates, high valuations and global growth were reflected in the sharp fall in equity markets during October. The major uncertainties facing investors that we have previously highlighted still prevail.

Globally, our key concerns are the effects of tighter monetary policy, sub-trend growth in Europe, geo-political tensions (an emerging new Cold War between the US and China) and fears of an escalating trade war (with investors hoping for a deal struck by Trump). The fallout from the midterm elections in the US will also be closely watched. The US capex cycle is slowing and this is somewhat worrying given its historical nexus with future US earnings. The key threat to global growth in the short-term is likely to come from a full blown trade war. The US has imposed fresh tariffs on China and the Chinese have retaliated. In early October, the IMF downgraded its 2019 outlook for both the United States and China, citing the deepening trade war between the world's two largest economies. The threat to valuations, as we've mentioned before, is interest rates rising further. There is also some concern that after a 10-year bull market in risk assets, we might be at peak earnings and profitability, making stocks trading on elevated multiples extremely vulnerable to a further correction, with dire consequences for the bull market. This has been borne out in earnings expectations being marked back to mid-single digits.

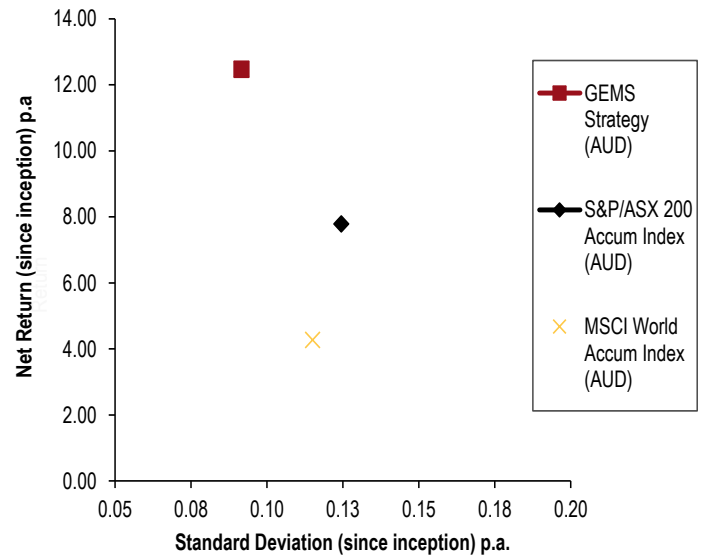
Domestically, our focus is the second-order effects of the above-mentioned uncertainties, along with sharply slowing credit growth, the fear of a harder economic landing and a pending Federal election some time in 2019.

As we remain attuned to heightened levels of market risk, the overall portfolio positioning has remained largely stable. The portfolio has slightly increased its long exposures to Europe, meanwhile increasing its short exposure to Australia and New Zealand. Sector weightings have not moved materially in any specific industry sector. The aggregate result is a higher level of gross exposure at 145% (versus 131% last month) and a marginally lower net exposure (from 80% to 78%) for the portfolio.

Market Exposure as a % of NAV



GEMS Strategy Performance & Volatility ^



Top Holdings (Alphabetical, Long only)

- ALPHABET INC
- BP PLC
- CATAPULT GROUP INTERNATIONAL
- CLOVER CORP
- GENERATION DEVELOPMENT CORP
- GRAINCORP
- HEALTHSCOPE
- NEWCREST
- PSC INSURANCE GROUP
- TRIBUNE MEDIA

Key Service Providers

REGISTRY:	Link Market Services Limited
AUDITOR:	Ernst & Young
PRIME BROKER:	Morgan Stanley Intl & Co PLC & Goldman Sachs International
ADMINISTRATOR:	Citco Fund Services (Australia) Pty Ltd
CUSTODIAN:	State Street Australia Limited

Source: Ellerston Capital

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.

ABOUT THE ELLERSTON GLOBAL EQUITY MANAGERS 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.

For further information, please contact:

INSTITUTIONAL CONTACT

Melinda Carter
+61 3 9002 2041
mcarter@ellerstoncapital.com

SYDNEY OFFICE

Level 11, 179 Elizabeth Street,
Sydney NSW 2000

RETAIL CONTACT

Andrew Seddon
+61 417 249 577
aseddon@ellerstoncapital.com

MELBOURNE OFFICE

Level 4, 75-77 Flinders Lane,
Melbourne VIC, 3000

Simon Glazier
+61 2 9021 7790
sglazier@ellerstoncapital.com

Ph: +61 2 9021 7797

E: info@ellerstoncapital.com

DISCLAIMER

[^] Actual performance for your account may vary from that set out in this newsletter and will vary for investments made in different classes, or at different times throughout the year. Some performance data is estimated and preliminary and subject to change.

^{^^} For the period 1 January 2002 to 30 April 2006, the CPH Group GEMS Portfolio was not operated within a separate fund structure. The underlying investment assets of the CPH Group GEMS Portfolio were owned during that time within corporate entities of the CPH Group for which audited accounts were prepared on an annual basis. Accordingly, in order to provide relevant historical performance information for the period 1 January 2002 to 30 April 2006 (Historical Returns) net returns were calculated on the basis of the actual dollar returns of the CPH Group GEMS Portfolio adjusted to reflect a fund structure similar to the Fund and including all fees. For GEMS B, GEMS A returns have been used between 1 May 2006 and 2 November 2009. The returns of the Fund and the relevant Indices are net of fees, expenses and taxes and assuming distributions are reinvested.

The returns and risk of the Fund and the relevant Indices are net of taxes, fees and expenses and assuming distributions are reinvested. The performance figures presented are for the Ellerston Global Equity Managers Fund GEMS C Units. The one month return figure may be an estimate and not the final return. This estimate also impacts other performance information provided. Estimated performance figures are preliminary and subject to change. Returns for other classes may differ slightly. Past performance is not indicative of future performance. Ellerston Capital Limited ABN 34 110 397 674 AFSL 283 000 is the responsible entity of the Ellerston Global Equity Managers Fund ARSN 118 887 095 (Fund). This newsletter has been prepared by Ellerston Capital Limited without taking account of the objectives, financial situation or needs of investors. Before making an investment decision you should consider your own individual circumstances and obtain a copy of the Product Disclosure Statement for the Fund dated 18 December 2017 which is available by contacting Ellerston Capital. This material has been prepared based on information believed to be accurate at the time of publication. Assumptions and estimates may have been made which may prove not to be accurate. Ellerston Capital undertakes no responsibility to correct any such inaccuracy. Subsequent changes in circumstances may occur at any time and may impact the accuracy of the information. To the full extent permitted by law, none of Ellerston Capital Limited, or any member of the Ellerston Capital Limited Group of companies makes any warranty as to the accuracy or completeness of the information in this newsletter and disclaims all liability that may arise due to any information contained in this newsletter being inaccurate, unreliable or incomplete.

[#] The standard deviation is often used by investors to measure the risk of an asset. The standard deviation is a measure of volatility: the more an asset's returns vary from the average return, the more volatile the asset. A higher standard deviation means a greater potential for deviation of return from the average return of the asset.