ELLERSTON CAPITAL

# Ellerston Australian Share Fund (ASF)

Performance Report | September 18

## PERFORMANCE SUMMARY

| Gross % | 1 Month | 3 Months | 1 Yr | 3 Yr p.a. | 5 Yr p.a. | Strategy Since Inception p.a. |
|---|---|---|---|---|---|---|
| ASF | -0.64 | 0.61 | 17.82 | 12.89 | 8.78 | 11.19 |
| Benchmark | -1.26 | 1.53 | 13.97 | 12.11 | 8.19 | 10.54 |

Past performance is not a reliable indicator of future performance.

## 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.

### Investment Objective

The Investment objective for the Ellerston Australian Share Fund is to outperform the S&P/ASX 200 Accumulation Index (Benchmark).

### Investment Strategy

The Fund uses a benchmark-independent, high conviction approach that looks beyond investing in the Top 20 stocks in order to capture the neglected opportunities created by under-researched stocks in the broader Australian market.

### Key Information

| | |
|---|---|
| **Strategy Inception Date** | 1 April 2009 |
| **Fund Net Asset Value** | $1.0400 |
| **Liquidity** | Daily |
| **Application Price** | $1.0426 |
| **Redemption Price** | $1.0374 |
| **No Stocks** | 18 |
| **Management Fee** | 0.90% |
| **Buy/Sell Spread** | 0.25% |
| **Performance Fee** | 15% |
| **Firm AUM** | Over $5 Billion |

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”.

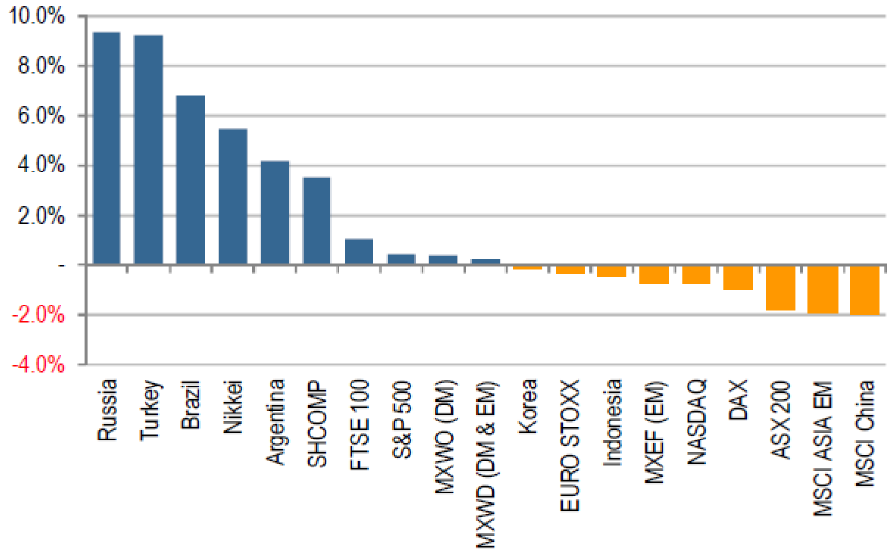
## Asia

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.

## COMPANY SPECIFIC NEWS

### The Market Misses

**Lynas Corporation (LYC -27.2%)**

LYC was impacted heavily during the month as speculation built that the newly formed Malaysian government would review the 12 year tax holiday status awarded by the previous government of its rare earth refinery in Kuantan. The sell-off was exacerbated when unconfirmed reports emerged that long-time anti-Lynas campaigner, MP Fuziah Salleh, was appointed to Chair the review of its operations, including its waste disposal treatment.

**Estia Health/ Regis Health/ Japara Health/ Aveo Group (EHE -20.2%/ REG -15.5%/ JHC -19.8%/ AOG -14.0%)**

The aged healthcare sector came under significant pressure as the Federal Government announced a surprise Royal Commission into the industry. Whilst the terms of reference have yet to be decided, increased risk, higher costs, greater public scrutiny and the potential for tighter regulation are likely to keep the sector under pressure for some time.

**Blackmores (BKL -18.5%)**

After a sizable bounce in August, BKL saw profit taking early in the month. The negative momentum intensified as fears over greater regulation of Chinese cross border e-commerce trade, predominantly in the Diagou channel, gained more headlines.

**Resolute Mining (RSG -14.2%)**

Following RSG's tough FY18 result which showed a 53% fall in profitability on the prior year, the combination of poor cash flow and increased capex expectations into FY19 weighed on the stock. Throw in a soggy gold price and there was limited support for the name.

**CSR Limited (CSR -12.5%)**

CSR came under further pressure during the month as concerns over Australia's cooling housing market deepened. Falling house prices, combined with weak July building approvals (-5.6% year-on year), had the 'wall-of-worry' building.

**Bega Cheese (BGA -12.4%)**

The market was surprised when BGA raised $250 million of new equity capital in September. The placement via a book-build looked opportunistic after a strong run in the share price and with management citing improved financial flexibility as its motivation. BGA recently acquired around a $20 million stake in Capilano Honey, holding 11% of the company and may end up being the true destination of part of the funds.

**CSL Limited (CSL -11.0%)**

CSL got caught up in profit taking across many of the higher PE ratio growth names in September. No other company has added more market cap to the Australian index in the last 12 months and it is not surprising to see a period of consolidation.

**The A2 Milk Company (A2M -11.0%)**

A2M got hit late in the month as it was disclosed that new CEO Jayne Hrdlicka, had sold her entire shareholding. Whilst the allocation of shares was compensation for entitlements lost on departure from Jetstar, the market was rightly worried about the lack of commitment that it demonstrated.

## The Market Hits

### Scottish Pacific (SCO +23.1%)

After a strong set of FY18 results, SCO's fine performance was recognised by private equity group Affinity Equity Partners, launching an agreed cash bid for the group at $4.40. The offer came with no conditions and was unanimously supported by the Board (in the absence of a superior proposal), so it appears that it's game over.

### Northern Star (NST +20.0%)

NST announced early in the month that it had acquired the Pogo mine in Alaska for $347 million. The acquisition was funded with a $175 million placement. The acquisition is significantly accretive and compliments NST's already strong earnings growth profile, which the market re-rated immediately.

### Vocus Group (VOC +15.1%)

VOC continued to benefit (in a re-rating sense), from the announced consolidation in the telecommunications sector between TPM and Vodafone. As the third player in fixed line and broadband, the market is hopeful that the new industry structure will see margins which have been under pressure, start to expand.

### Monadelphous Group (MND +14.5%)

Oil is back and so with it the fortunes of the energy service sector, or at least that's how the theory goes. After a tough year where MND significantly underperformed the market, its fortunes turned as investors looked for more leveraged ways to play the rally in oil.

### Pilbara Minerals (PLS +11.8%)

PLS announced that it was ready for its first shipment from its Pilgangoora lithium mine. In addition, the quality of the lithium extracted from the mine appears to be battery-grade, further enhancing the economics of the project.

### Whitehaven Coal (WHC +14.3%)

Hard coking coal rallied above US$200/tonne during September, breaking what appeared to be a longer-term slide. The rise in the bulk commodity snapped a three month losing streak for WHC which had seen it sell off more than 20% from its highs at the end of June.

### Sigma Health (SIG +10.5%)

The roller-coaster ride for SIG shareholders continued in September, after the large sell-off in July when it announced that it had lost its supply contract with Chemist Warehouse. Whilst replacing those earnings will be difficult, the market will be closely monitoring the prospect of any new distribution agreements.

### Beach Energy (BPT +10.3%)

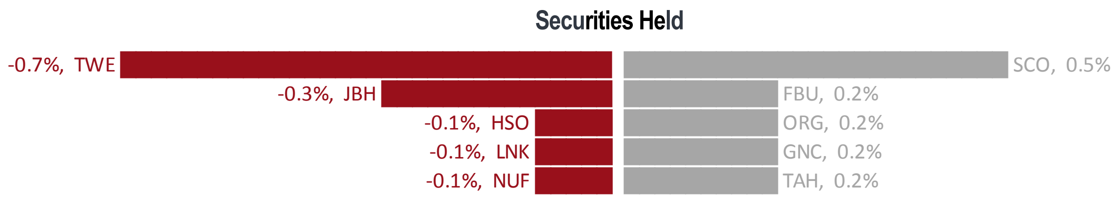
Of the energy stocks, BPT is the most leveraged to rising oil prices and continued its rally which has seen the company double its market capitalisation over the last 12 months. In addition, at its strategy day where the management gave bullish five year production forecasts of 34-40 mmboe coupled with solid free cash flow forecasts, analysts generally walked away positively.

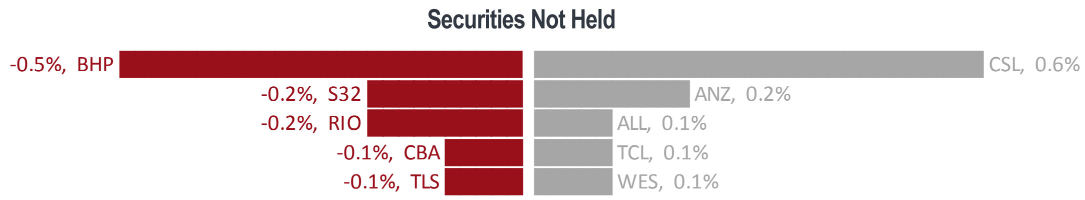
# FUND PERFORMANCE

In a period high volatility and reduced forward earnings, your Fund delivered a return of -0.64%, outperforming the benchmark return of -1.26% over the period. The environment was challenging to say the least and once again, the dispersion of returns were staggering both for the hits and the misses.

| Returns[1] (%) | Gross | Benchmark* | Excess | Net |
|---|---|---|---|---|
| 1 MONTH | -0.64 | -1.26 | 0.62 | -0.73 |
| 3 MONTHS | 0.61 | 1.53 | -0.92 | 0.35 |
| ROLLING 12 MONTHS | 17.82 | 13.97 | 3.85 | 16.68 |
| 3 YEARS (P.A.) | 12.89 | 12.11 | 0.78 | 11.72 |
| 5 YEARS (P.A.) | 8.78 | 8.19 | 0.59 | 7.64 |
| SINCE INCEPTION (P.A.) | 11.19 | 10.54 | 0.65 | 10.00 |
| SINCE INCEPTION (CUM) | 173.93 | 159.15 | 14.78 | 147.38 |

Past performance is not a reliable indicator of future performance.




The main contributors to this month's outperformance were overweight positions in core holdings such as Scottish Pacific (SCO +23.1%), Fletcher Building (FBU +2.4%), Origin Energy (ORG +3.9%), Graincorp (GNC +1.2%) and Tabcorp (TAH +1.5%).

Having zero holdings in CSL (CSL -11.0%), Australia and New Zealand Banking Corp (ANZ -4.5%), Aristocrat Leisure (ALL -10.0%), Transurban (TCL -5.5%) and Wesfarmers (WES -3.1%) also had a positive contribution to performance.

The main detractors from performance were overweights in Treasury Wines (TWE -9.4%), JB Hi-Fi (JBH -4.6%), Healthscope (HSO -2.5%), Link Administration (LNK -0.1%) and Nufarm (NUF -2.2%).

Not holding any leading mining stocks, namely BHP Billiton (BHP +7.2%), South32 (S32 +15.3%) and Rio Tinto (RIO +8.3%), coupled with a zero weight towards Commonwealth Bank (CBA +0.2%) and Telstra (TLS +2.9%) which enjoyed a short-term relief rally during the month also weighed on performance relative to the benchmark.

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[1] 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.

# FUND ACTIVITY

| NEW STOCKS ADDED | STOCKS EXITED |
|---|---|
| • Challenger<br>• Computershare | • APN Outdoor Group (taken over) |

| POSITIONS INCREASED | POSITIONS DECREASED |
|---|---|
| • Bluescope Steel<br>• Origin Energy<br>• Healthscope<br>• Treasury Wines Estates<br>• Woodside Petroleum<br>• QBE Insurance Group | • Link Administration<br>• Tabcorp Holdings |

The Fund was highly active over the course of the month. We successfully exited our large position in APN Outdoor Group following its all cash $6.70 takeover offer by JCDecaux. If you recall, when we introduced the stock to the portfolio, it was a very contrarian call given the woes faced by APO caused by the loss of major contracts impacting short-term profitability. James Warburton (who replaced previous CEO Richard Herring) has done a stellar job in a short period of time steadying the ship and getting this quality business back on the right footing, prompting the French to move on the company. We re-deployed the proceeds by taking the opportunity to add to other core holdings where we see further upside and a better risk/reward payoff.

Importantly, we also introduced two new stocks into the portfolio (with detailed comments below).

We introduced **Challenger** (CGF) into the portfolio in September for the first time. We have been attracted to the long-term drivers of the stock, but until recently, were deterred by the high implied valuation. The sharp pullback in CGF's share price from lofty highs of over $14.00 in January of this year back towards $10.46 (where we commenced our purchases) at a time when management have de-risked the book has provided us with what we believe is an attractive entry point.

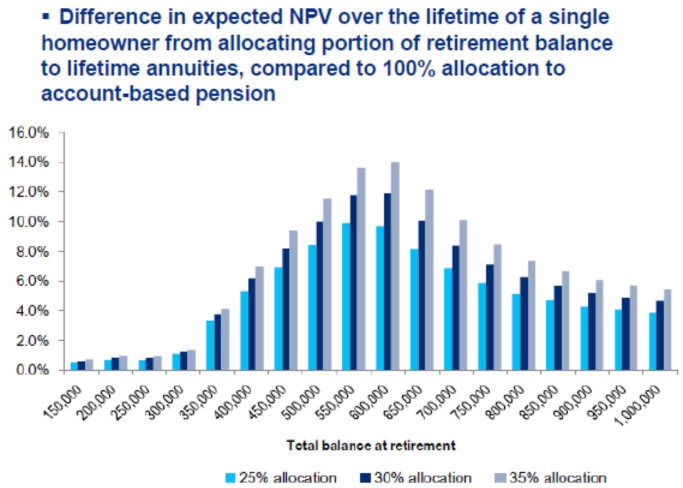
CGF is the most significant provider of annuities in Australia and has about 90% market share. An aging population and greater longevity are demographic themes in its favour. The shift from the accumulation phase of retirement savings to the draw-down phase in retirement has received greater focus from government, regulators and individuals. Regulatory changes to facilitate this transition and alleviate longevity risk, along with DSS changes recalibrating pension eligibility, favour CGF, through the likely increased use of annuities and annuity-like products and funds management services.

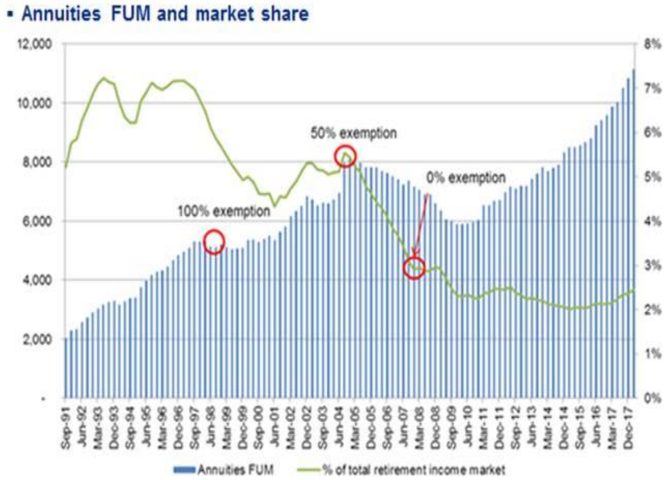
CGF's share price has been weak recently on the back of slightly lower sales and a theory out there that the share price won't do well in a rising interest rate environment. We believe that both those points have been overplayed, and in addition suggest the market is missing a significant positive structural change that has occurred with government means testing rules for annuities now relaxed, where the annuity market could more than double in size. CGF is the best placed to capitalise on that structural change.

**Structural Benefits**

There's a structural benefit to CGF coming on the back of new means-test rules announced at the Federal Budget in May. Customers now only have to include 60% of an annuity in the asset test for the aged pension, rather than 100% previously, which means they are better off buying an annuity, as they still receive the age pension. Market analysis shows that they could be up to 15% better off (see chart on left below). This is a significant selling point for annuities when the new rules come into effect on 1 July 2019, perhaps not fully appreciated by the market. Before the annuities exemption was first reduced by the government in 2005, and later scrapped totally in 2007, the annuity market share of the retirement income market in Australia was double in size at approximately 5% (see chart on right below). So it's reasonable to expect a strong rebound in market size when this rule comes into effect, as annuities currently only capture 2.5% of retirement flows.

Additionally, the recent government review paper recommended 15-20% on retirement amounts into annuities. While it may be a stretch to suggest this will become compulsory, it is clear that there is a desire by government to have annuity products representing a greater proportion of retirement solutions. This will no doubt bring more competition into the Australian market as the annuity market grows significantly, however CGF has the first-mover advantage, scale and importantly, the distribution capabilities that competitors will have to cultivate, develop or acquire over time. CGF's distribution platforms include, the Colonial platform, AMP, BT, and HUB24 underway, with further platform opportunities ahead.




Source Citi Research

**Industry funds opportunity**

The other major opportunity is to tap into the Industry Funds which represent 1/3 of the existing market, as CGF currently only sells through advisors into the retail market. Bears argue some industry funds may not want to partner with CGF, but with deferred lifetime annuities, they will offer members a beneficial retirement solution. CGF is in advanced discussions with Industry Funds and an agreement should be positively received by investors.

**Other key reasons to own CGF,** other than the demographic tailwinds from an ageing and relatively wealthy population retiring, on top of the regulatory changes.

- Labor Government potential reforms (negative gearing & franking credit refund) reduces return on alternative, competing retirement strategies.
- Near-term sales momentum: CGF reported double digit growth in lifetime annuity sales in July 18, with quotes up 20%. Mitsui sales were also encouraging in July, with upside from the BT Panorama and Hub24 platform connections.
- Margins should eventually stabilise: These have been falling over time as the richer back book rolled off, but ought to stabilise as and when CGF is able to shift its mix towards longer-dated (and higher-margin) annuity sales from lifetime annuities and Japanese sales .
- Mitsui on register, only at 10% now, but could go up to 15%.
- CEO did not sell stock on vesting this year, and has done so every other year for some years.
- Capital intensity is falling as a change in asset allocation with the shift from property to fixed income, this sets up CGF to build a more sustainable, scalable business model to capitalise on the favourable regulatory changes discussed above. There should be an incremental benefit in FY19 as the asset mix shift continues. This is an important change underappreciated by the market.
- Investment boutiques have been demonstrating strong growth in FUM.

**Rising Interest rates impact**

- Sales: Rising rates are more likely to be positive for sales given it's easier to sell long-dated annuities at higher rates of return to customers compared to locking in record low interest rates.
- Earnings and Margins: Rising rates are more likely to lead to higher margins due to 1) higher return on shareholder funds backing annuities and 2) likely higher product spreads. It's similar to the banking sector where you can generate a bigger spread when rates are higher, say 6%, as it's easier to pay depositors 5% and charge borrowers 8%, but when rates are 1.5% you can't pay depositors much below 1.5%.
- Balance sheet: CGF has a large book of fixed interest assets backing both policyholder liabilities and CGF's own shareholder funds. The policyholder assets are matched with liabilities - so any fall in asset values should be offset by an equal fall in liabilities. There is some risk of a negative one-off impact from the shareholder assets (which are not offset by liabilities), but these are largely shorter-dated, so the impact should be relatively small. CGF's shareholder funds at 2H18 were $3.0 billion. The company does not split out the asset allocation for shareholder funds, but across both policyholder and shareholder funds, 65% is allocated to fixed income. Similarly, CGF doesn't split out the duration for just shareholder funds, but across the whole book it's an average of 3.3 years. They have $2.7 billion of CET1 capital, and have a PCA (prescribed capital amount) of $2.5 billion, which is made up almost entirely of asset risk charge. This is calculated as a percentage of assets held, with higher weighting for riskier, less liquid asset classes. CGF targets capital of 1.35-1.6 times PCA, with its current position approximately $130 million above the midpoint of the range.
- A +1% rise in interest rates at 3 year duration would be a 3% fall in value of a fixed income asset. Assuming the same 65% asset allocation for shareholder funds, it will be a hit of circa $60 million, and circa $120 million for a 2% move. Given APRA's asset risk charge at an average 7.5% capital weighting, the net hit to surplus capital (net of the fall in capital requirements) should be approximately $55 million and $110 million respectively. So at the high end, a +2% move higher in interest rates means CGF's will still be in their targeted PCA range.

**Other**

- Bears will also talk to sales being slower recently, but we focus on Book growth which is being maintained.
- Longer-term annuities are being sold, so sales will be lower, because there is less churn in the book, yet the overall book growth is what earnings are ultimately driven off. Near-term sales momentum is set to return as discussed above and CGF recently confirmed this with quotes up 20% in July.
- Japan sales: Bears pushing the thesis that Japan sales will be weak on the back of higher US-treasuries, the key is that AUD has fallen significantly which makes annuities here even more attractive.

**Valuation**: CGF is currently trading on a 1-year forward PE of just over 15 times, with approximately 10% EPS growth. We are attracted to the stock's leveraged structural growth.

During the month we also introduced **Computershare (CPU)** into the portfolio. We commenced buying CPU at $18.88. We have owned CPU in the portfolio in the past. The investment case this time around is predicated on its leverage to higher interest rates, its $US income stream, and quality management executing well on their cost out strategy.

We highlight the following key points:

**Margin income**: Margin income (8% of FY18 revenue) was up 37% year-on-year after bottoming back in FY17. It is earned by CPU at no additional cost, and drops straight to the bottom line. With a continued upward trajectory in rates and some reduction in CPU's hedging arrangements, we see potential for margin income to double, and estimate its contribution could climb to 14-15% of group revenue in the next three years.

**Mortgage services**: Mortgage services is the group's largest growth engine, accounting for 24% of revenues and 20% of EBITDA in FY18, which was up 65% year-on-year. CPU participates in both the UK and US markets, and does not take on credit risk, but provides services across the majority of a mortgage lifecycle. These include origination services to bankers, due diligence, acquiring mortgage servicing rights (MSRs, which are somewhat capital intensive), winning sub-servicing contracts and servicing these loans. We think rising mortgage rates should see higher margin income, increase the value of CPU's purchased MSRs and see lower rates of refinancing. This could drive a stickier book of loans, though we acknowledge that it may be offset by a softer origination market. In the UK, CPU's UKAR contract win in 2016 has proven quite transformational for the business (GBP 30 billion managed on a seven-year contract), making CPU the largest third-party provider of mortgage services. The business' profitability continues to improve as CPU migrates loans onto its own platform (and eventually intends to decommission the legacy platform) to drive operating leverage.

**Corporate activity**: Remains elevated for the time being with strong M&A and transaction activity across the market. Corporate actions revenue was up 28% year-on-year in FY18 (after falling for four consecutive years). While we expect a slight slowdown in FY19, we think positive macro indicators could continue to see upside risk to CPU's more cyclical businesses.

**Cost-out plans**: CPU has to-date announced three stages of cost-out plans, totalling US$125-$155 million in savings across multiple business segments over FY17-23. Due to the nature of CPU's servicing businesses (repetitive, labour-intensive, prone to human error), we think the group will be a potentially significant adopter of Robot Process Automation (RPA), which should drive further upside to management's already announced savings.

**Earnings diversity**: CPU is one of few Australian-listed companies which derives the majority of its earnings offshore and offers geographical (as well as business) diversity to earnings. Only 11% of FY18 revenue was earned in ANZ, with the majority of revenue earned in North America (56%) and UCIA/Europe (26%).

**Valuation**: CPU is currently trading on a 1-year forward PE of 18 times with EPS growth of 12%. Given its offshore earnings stream, we think the risk to profits is to the upside.

We have also **significantly lifted the Fund's energy exposure** via strengthening existing positions in both **Woodside** and **Origin Energy**, where we believe there have been dramatic changes in the global dynamics of the oil and gas industry. The short to medium-term risks are skewed to the upside as the oil market has entered a new phase based on very strong demand growth of 1.6% and tight supplies (where by April 2018, inventories fell below 5-year averages). The Trump administration's sanctions against Iran (which commence on 4 November) are expected to further tighten an already constrained market where Venezuelan oil production is falling fast and OPEC spare capacity may not be enough to fill the breach.

The same applies to the LNG market where demand has risen significantly in China, India and in other emerging markets just at a time where, post the surge in new supply from 2011 to 2015, there has since been a lack of Final Investment Decisions to bring on further new capacity. This coincides with a period where Japan may miss its nuclear target, so it may be too late to address the pending LNG supply shortfall.

# FUND STRATEGY AND OUTLOOK

The Fund's strategy and our outlook have not changed since last month, the only difference being that US interest rates are higher, with the 10 year yield fast approaching 3.25%, while oil prices are much higher.

**The major uncertainties facing investors that we highlighted last month persist. Globally, they are the effects of central bank tapering and tighter monetary policy/financial conditions, sub-trend growth in Europe, geo-political tensions, and fears of an escalating trade war. Domestically, they include the second-order effects of the global issues along with slowing credit growth and a pending Federal election sometime next year.**

A point worth stressing is that as a consequence of the release of the interim report from the Royal Commission into Banking, the probability of slower credit growth domestically has significantly increased. While the commissioner didn't make any recommendations in the interim report, he has set the stage for recommendations on tighter assessment and verification of income and expenditure, and a stricter view on industry remuneration structures. Tighter verification standards are likely to reduce the amount of credit consumers could access and changed remuneration structures (along with greater regulatory scrutiny) are likely to increase the risk aversion of bank executives.

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. The threat to valuations, as we've mentioned before, is sharply rising rates.

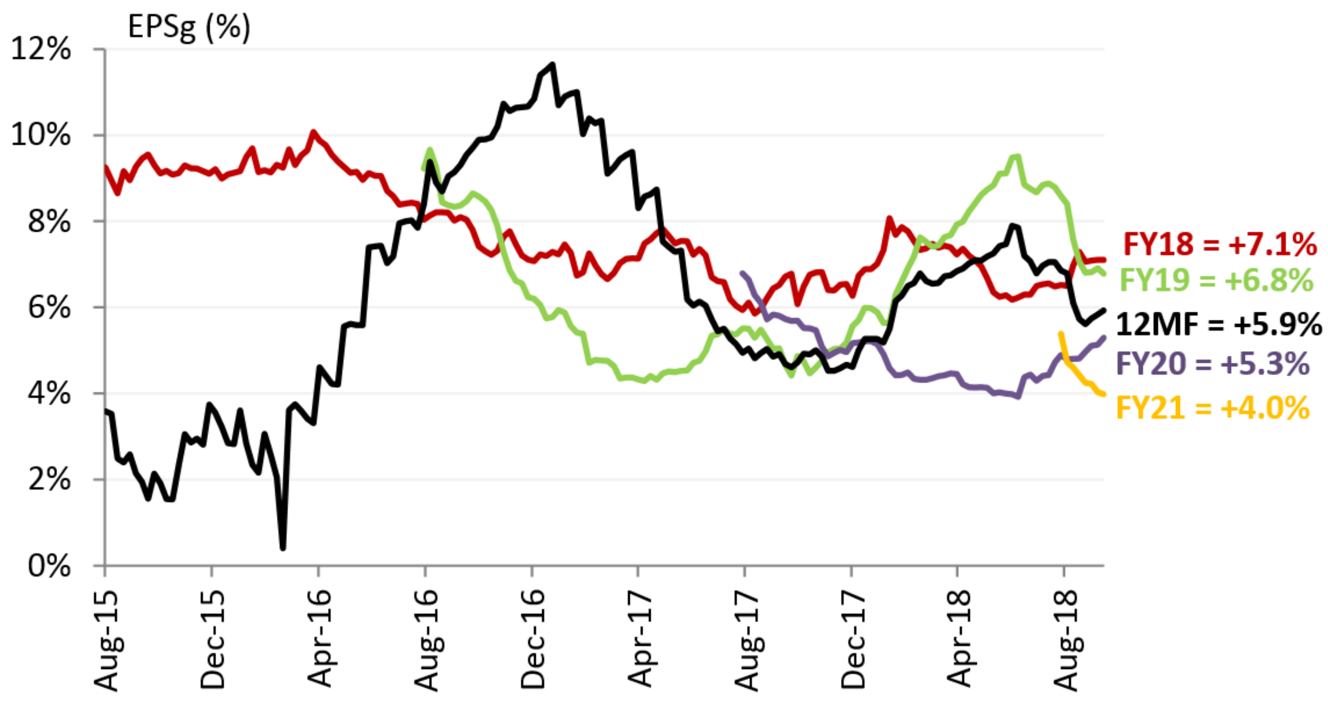
**In terms of formulating strategy, decelerating growth, rising inflation pressures (the potential for the oil price to spike further) and tightening policy continue to paint a cautious backdrop for risk assets.** For Australia, the outlook for domestic equities in FY19 appears very subdued, as a credit squeeze will no doubt weigh on the consumer, housing and the banking sector.

Rising oil and LNG prices should fuel energy stocks with earnings upgrades highly likely, as analysts continue to play catch up by using higher oil and gas prices as they mark to market their base case forecasts towards spot pricing.

**Domestic valuations remain stretched, despite global underperformance:** The ASX 200 is still trading 6% above its 10-yr average 12 month-forward multiple at 15.3x, with Industrials ex-Financials trading 1.8 standard deviations rich at 21.2x, with Energy the only sector trading below its 10Y average P/E.

MSCI Australia lost its resilience in 3Q, underperforming peers in September and CYTD.

**The chart below shows that earnings expectations have been marked back to mid-single digits.**




Source: RIMES, Morgan Stanley Research.

**Australia has given back much of the regional and global outperformance enjoyed from mid-June to mid-August.** The reality of material domestic headwinds in the housing-linked stocks, combined with significant regulatory and policy cross currents impacting many sectors have taken much of the gloss off Australia's "DM within EM" appeal (see chart below).


Source: Bloomberg, Morgan Stanley Research.

**Despite this give up, we remain very cautious.**

**Against this backdrop and with markets continuing to flirt with all-time highs, we will stick to our bottom-up approach and continue to pick stocks that we believe offer superior earnings growth, good turnaround prospects and compelling valuation upside.**

We have provided our segmented portfolio positioning below:

- **Quality Franchises/Defensive characteristics**

  Solid companies with strong/leading market positions and credible management with good balance sheets.

  *Treasury Wines, Tabcorp, Challenger Ltd, Link Administration and Computershare*

- **Quality Business, but cyclical in nature facing certain headwinds**

  Companies with strong market positions and strategic assets, but very sensitive to economic conditions/seasonality/weather.

  *Graincorp/ Nufarm (both experiencing the driest conditions for many years), JB Hi-Fi and Star Entertainment*

- **Turnarounds**

  Sound businesses that have historically generated poor returns, have been badly managed, under-earned versus their potential, are in transition, and where we think earnings/returns will improve over the medium-term.

  *QBE, Fletcher Building and Healthscope (received takeover approach, but no Board engagement)*

- **Deep Value Cyclical/Material and Energy Plays**

  Stocks trading at discounts to NPVs, with growth optionality, at a turning point in the cycle.

  *BlueScope Steel (over 200m t of Chinese higher cost capacity taken out of the market), Woodside Petroleum and Origin Energy*

- **Zero Banks** (a position held for some years now, with all the chickens slowly coming home to roost)

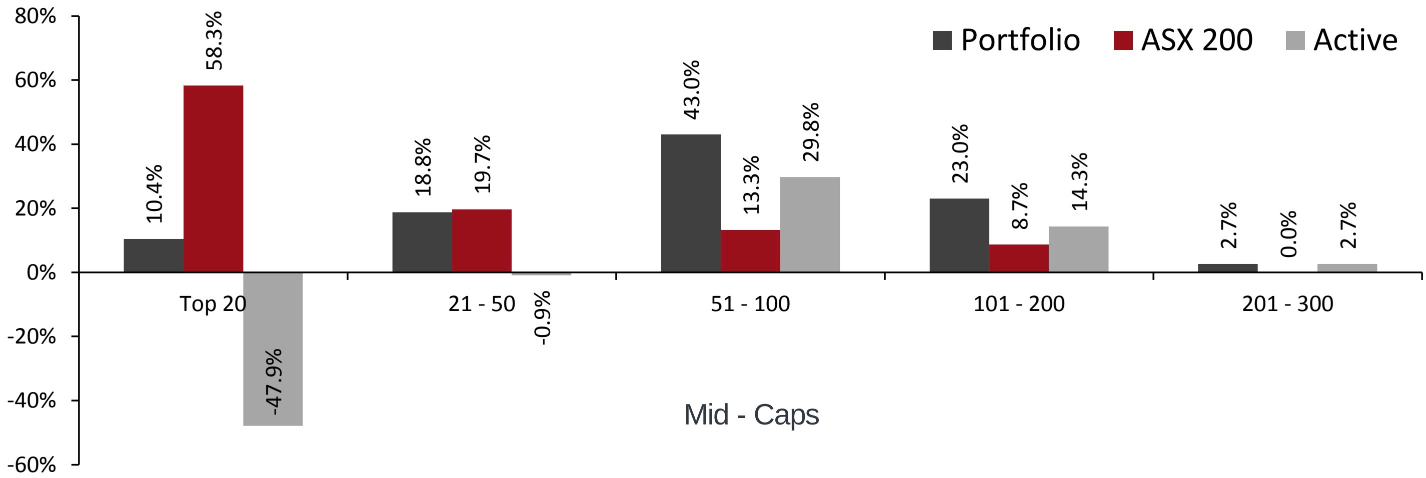
Warm Regards,

Chris Kourtis

Portfolio Manager

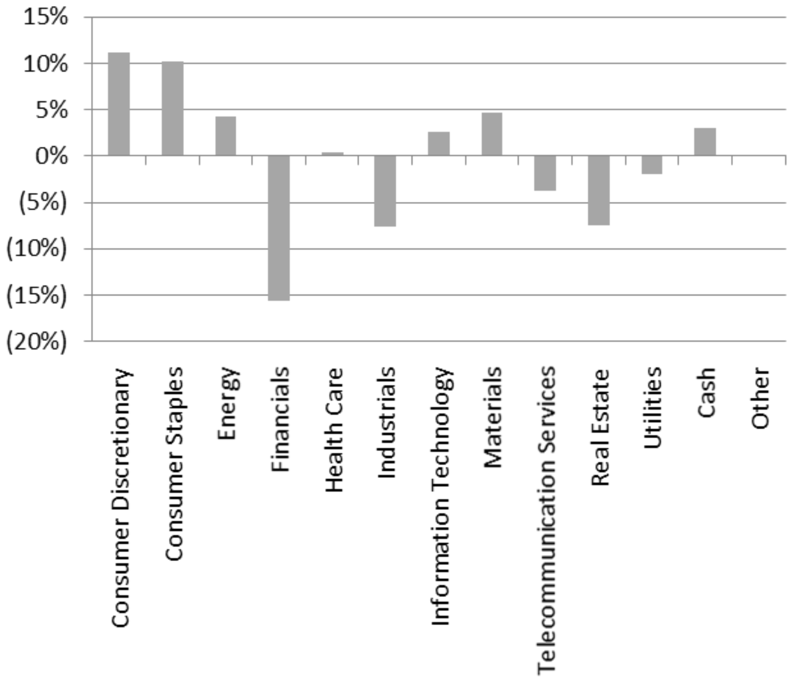
# PORTFOLIO FEATURES

## Size comparison Chart vs ASX 200^




^Size Comparison Data as at 1 October 2018
Source: Bloomberg, Ellerston Capital Limited

## Active Sector Exposures*




| TOP 10 HOLDINGS** |
|---|
| GRAINCORP |
| TREASURY WINE ESTATES |
| HEALTHSCOPE |
| BLUESCOPE STEEL |
| JB HI-FI |
| QBE INSURANCE |
| ORIGIN ENERGY |
| FLETCHER BUILDING |
| NUFARM |
| TABCORP HOLDINGS |

* 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.

** Top 10 Holdings are listed in alphabetical order.

# 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 | $3.5 BILLION |
| FUNDS UNDER MANAGEMENT – ASF UNIT TRUST | $54 MILLION |
| APPLICATION PRICE | $1.0426 |
| REDEMPTION PRICE | $1.0374 |
| NUMBER OF STOCKS | 18 |
| INCEPTION DATE | 1 APRIL 2009 |

**For further information, please contact:**


**INSTITUTIONAL CONTACT**

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

**RETAIL CONTACT**

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

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

**SYDNEY OFFICE**

Level 11, 179 Elizabeth Street,
Sydney NSW 2000

**MELBOURNE OFFICE**

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

Ph: +61 2 9021 7797
E: info@ellerstoncapital.com