

Ellerston Overlay Australian Share Fund (OASF)

Performance Report | October 18

PERFORMANCE SUMMARY

Gross %	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.	Strategy Since Inception p.a.
OASF	-5.71	-5.10	2.62	8.44	6.44	10.94
Benchmark	-6.05	-5.92	2.94	8.25	6.02	10.06

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.

Investment Objective

The Investment objective for the Ellerston Overlay ASF 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 Australian equity stocks in order to capture the neglected opportunities and uses derivatives to enhance income

Key Information

Strategy Inception Date	4 January 2012
Fund Net Asset Value	\$1.0851
Liquidity	Weekly
Application Price	\$1.0878
Redemption Price	\$1.0824
No Stocks	17
Management Fee	0.90%
Buy/Sell Spread	0.25%
Performance Fee	15%
Firm AUM	Over \$5 Billion

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.

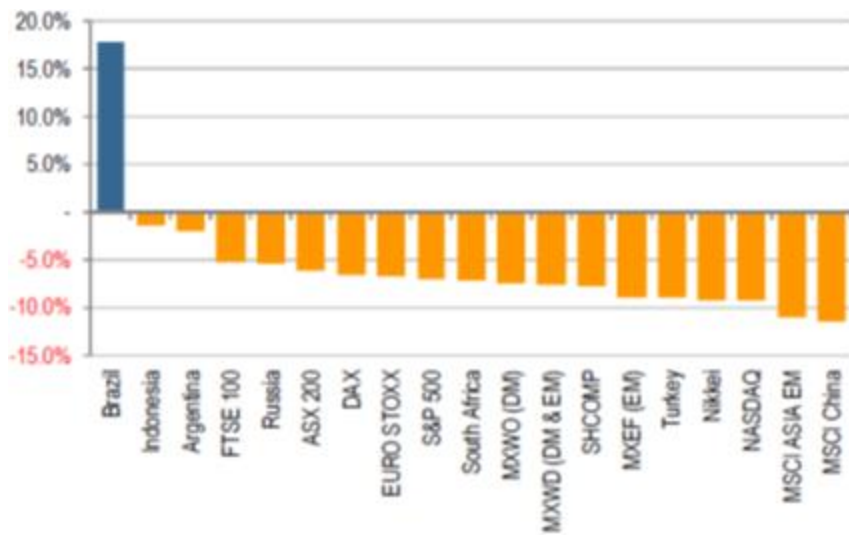
The European Central Bank kept rates unchanged in October as its view on the risks to growth were still described as "broadly balanced".

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.

COMPANY SPECIFIC NEWS

The Market Misses

Corporate Travel Limited (CTD -34.3%)

CTD went into trading halt at the end of the month after a report issued by VGI Partners highlighted amongst other issues, accounting anomalies surrounding wages, cash flow and revenue recognition. The company rejected most of the "20 red flag" allegations in the report, suggesting they were not supported by facts. The stock sold off aggressively upon re-opening as investors adopted a "shoot now, ask questions later" approach to finish down 34% for the month.

Syrah Resources (SYR -30.4%)

SYR had another tough month and has now fallen close to 70% from its highs in early January. Impacting the company in October was a fire at its Balama graphite plant which was expected to halt production for 5 weeks. Another operational issue for the company is adding to the wall of worry.

Afterpay Touch (APT -30.4%)

APT was impacted by a surprise proposed Senate inquiry into the finance sector covering payday lenders, debt management companies and buy now/pay later firms. As one of the high profile names in the area, APT felt the brunt of the market's concern, despite the company embracing the review.

Bellamy's Australia (BAL -29.3%)

BAL continued its downward slide with its shares slumping below \$8, a long way from its March 2018 peak of \$22. A tepid update at its AGM, where the company pointed to sales guidance at the low end of its 0-10% range, fuelled concerns. Regulatory approval of its Chinese-label formulation remains elusive, a key question mark over the company.

Domain/Nine Entertainment/Fairfax Media (DHG -29.1%/ NEC -25.2%/ FXJ -22.4%)

The media trio issued trading updates as part of the approval process for the merger between Fairfax and Nine. The weak property market, particularly in Sydney, has discouraged home owners from listing their properties for sale on the Domain website and in FXJ newspapers. The television advertising market has also cooled. The revenue weakness for DHG is likely to be cyclical, however for NEC, it could be a return of the structural decline in advertising revenues as viewers continue to turn away from traditional TV. Alas, the market did not discriminate and all three stocks were sold down heavily.

Wisetech Global (WTC -27.3%)

WTC got caught up in the sell-off of high PE stocks across October, despite a small upgrade to guidance. The company continued on its merry roll-up acquisition way, picking up two businesses during the month, one based in Sydney and another in Stockholm.

WorleyParsons (WOR -24.7%)

WOR's fall from grace was swift. Pressure across the energy sector driven by a sell-off in crude prices, was met with an acquisition which totally underwhelmed the market. A massive US\$3.3 billion acquisition of Jacob's Energy, Chemicals and Resources Business was a huge bite and many questioned the quality of the assets acquired and whether WOR had in fact bought at the very top. Worley's de-rating reflected those concerns.

Bingo Industries (BIN -23.9%)

Occasionally companies make their way into the hits and misses despite limited to no news flow across the month. A strong run in the few months prior was enough to see BIN sell-off and not even on-market buying from Directors could arrest the decline.

AMP Limited (AMP -22.6%)

AMP was punted again in October, this time for selling its wealth protection and mature business to Resolution of the UK for significantly less than market believed it was worth. The loss of franking credits, higher costs and lower earnings were estimated by some to have destroyed up to \$2 billion of shareholder value. The 22.6% sell-off across the month backed up that number almost to the dollar.

Kogan.com (KGN -50.0%)

Kogan was absolutely savaged during October as the company unexpectedly downgraded earnings, citing weakening sales in its global brand offer. The company, somewhat quizzically, blamed GST avoidance by foreign websites as the central cause of the weak sales. Given the sizable recent equity sales by founders Ruslan Kogan and David Schafer, the market was sceptical and severe. Cuts to EPS of approximately 30% flowed from the street and the stock halved.

The Market Hits

Saracen Mineral/ St Barbara/ Regis/ Evolution Mining (SAR +31.4%/ SBM +19.2%/ RRL+13.4%/ EVN +12.5%)

The gold bugs were out in force during October as participants sought refuge in the precious metal. SAR was the pick of the sector after it announced record quarterly production of nearly 90k ounces. Cash continues to build on its balance sheet and with 7 more years of production in the pipeline, investors appear comfortable.

Lynas Corporation (LYC +30.4%)

LYC was sold down aggressively in September as speculation built that the newly formed Malaysian government would review its rare earth refinery in Kuantan. A strong production result in the September quarter and the switch to a more scientific-based review of its refinery (as opposed to political) improved investor sentiment markedly.

MYOB Group (MYO +13.7%)

Perennial underperformer (at least against its software peers) MYO was bid for by private equity house KKR during October. MYO had traded sideways over the last 5 years and whilst the 20% premium feels attractive, it would be disappointing for the software provider, with investors expecting a bump.

Navitas (NVT +13.4%)

Another name to survive the October sell-off was NVT. Like MYO, its lifeline came in the form of a takeover offer. The Australian Super and BGH Capital consortium saw value in the education space that had eluded other market participants. An offer of \$5.50 per share was a sharp premium to the low \$4 range it was trading in, but was very much in-line with its trading range over the last 4 years.

FUND PERFORMANCE

In a period of high volatility across the entire breadth of the market, your Fund delivered a return of -5.71%, slightly outperforming the benchmark return of -6.05% over the period.

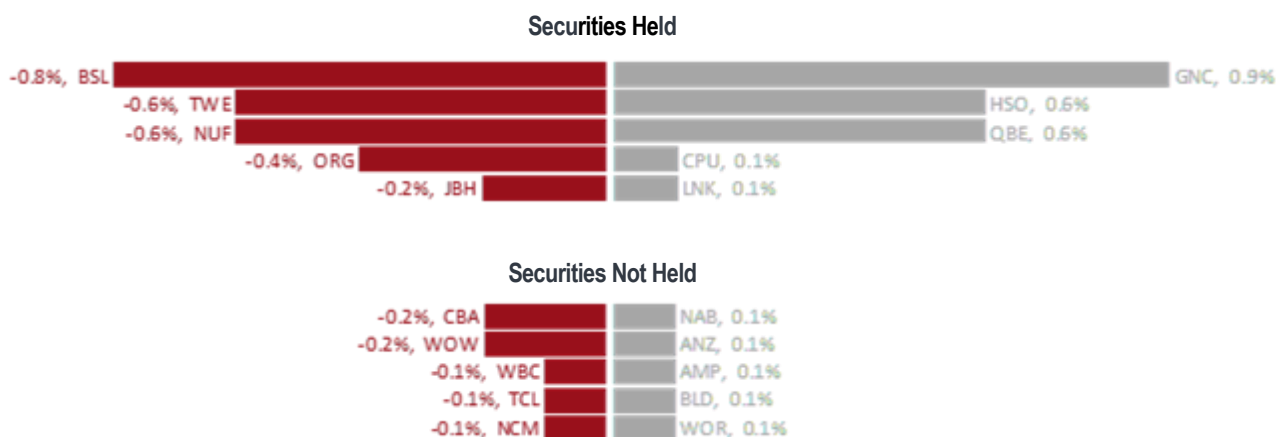
Returns ¹ (%)	Gross	Benchmark	Excess	Net
1 Month	-5.71	-6.05	0.34	-5.80
3 Months	-5.10	-5.92	0.82	-5.33
Rolling 12 Months	2.62	2.94	-0.32	1.81
3 Years (p.a.)	8.44	8.25	0.19	7.58
5 Years (p.a.)	6.44	6.02	0.42	5.49
Since Inception* (p.a.)	10.94	10.06	0.88	9.84
Since Inception* (cum)	103.33	92.54	10.79	89.92

¹ Returns are calculated using the Fund's redemption price and are net of fees and expenses. Returns are also calculated on the basis that distributions are reinvested. Returns of the Fund may include audited and un-audited results.

The benchmark was changed to the S&P/ASX200 Accumulation Index on 4 January 2012. Past performance is not a reliable indicator of future performance.

*Since Inception is 4 January 2012.

Source: Ellerston Capital Limited



Source: Ellerston Capital Limited

The main contributors to this month's outperformance were overweight positions in core holdings including Graincorp (GNC +4.3%), Healthscope (HSO +0.5%), QBE (QBE +1.8%), Computershare (CPU -0.9%) and Link Administration (LNK -3.6%).

Having zero holdings in National Australia Bank (NAB -9.4%), Australia and New Zealand Banking Corp (ANZ -9.0%), AMP (AMP -22.6%), Boral (BLD -18.8%) and Worley Parsons (WOR -24.7%) also had a positive contribution to performance.

The main detractors from performance were overweights in Bluescope (BSL -15.4%), Treasury Wines (TWE -13.6%), Nufarm (NUF -12.7%), Origin Energy (ORG -11.7%) and JB Hi-Fi (JBH -8.7%).

Having a zero holding in many popular Large Cap stocks such as Commonwealth Bank (CBA -3.1%), Woolworths (WOW +1.2%) and Westpac Bank (WBC -3.9%), Transurban (TCL +1.1%) and Newcrest Mining (NCM +6.2%) had a negative effect on the relative performance of the portfolio.

FUND ACTIVITY

new stocks added	stocks exited
<ul style="list-style-type: none"> None 	<ul style="list-style-type: none"> Scottish Pacific Group
positions increased	positions decreased
<ul style="list-style-type: none"> Bluescope Steel Computershare Nufarm Origin Energy 	<ul style="list-style-type: none"> Link Administration

In October, we did not introduce any new stocks into the portfolio. We exited Scottish Pacific Group following a takeover offer from Affinity Equity Partners.

Activity centred on increasing the funds position in core holdings (Bluescope Steel, Nufarm and Origin Energy) that looked highly oversold relative to our longer term assessed value. We also increased the funds position in relatively new holding (Computershare) to achieve a more meaningful weighting in the portfolio, where we have high conviction.

The most significant downsizing in weighting in the portfolio was to Link Administration (LNK). It has been widely speculated in the press that LNK, along with a consortium of investors, might via a dual track process, launch a bid for PEXA - Australia's first and currently, only operational online property lodgement and settlement network. Our concern was that LNK's balance sheet might be stretched post the potential acquisition of PEXA, given the speculated price of approximately \$1.6 billion for the asset, which would be dilutionary in the short term. This along with some concerns on the retention of a major client in LNK's funds administration business unit, led us to take profits and reduce the position to mitigate this risk.

FUND STRATEGY AND OUTLOOK

Apart from doing some selective buying during the sell-off, the Fund's strategy and our outlook has not changed. 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, they 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 upcoming 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 (see chart below).

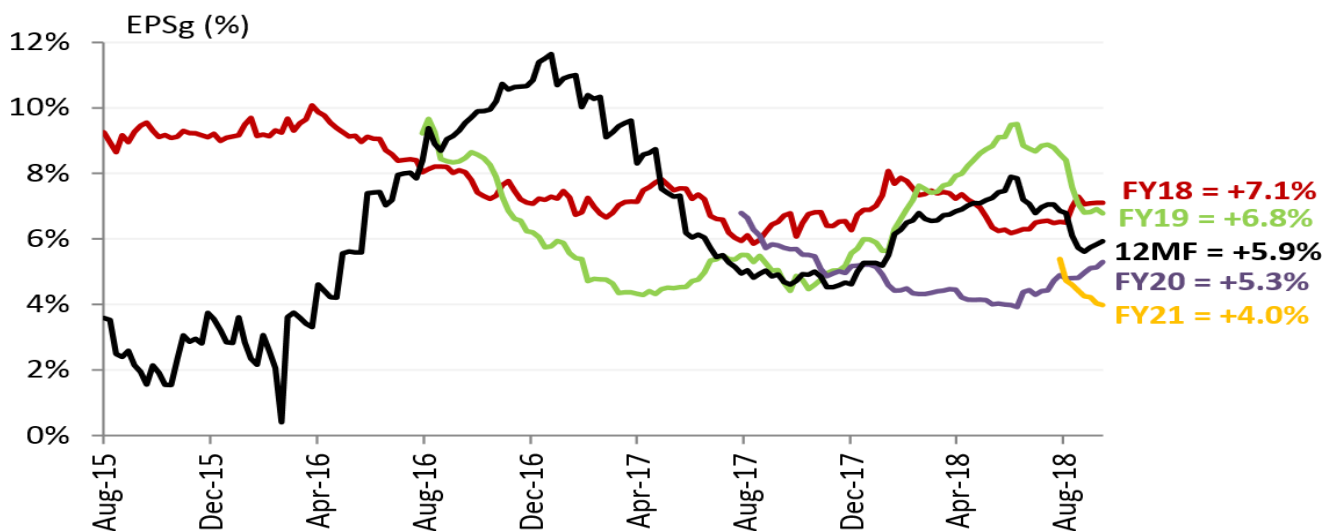


Source: Deutsche Bank Research

Domestically, they include the second-order effects of the above mentioned global uncertainties, along with sharply slowing credit growth, the fear of a harder economic landing and a pending Federal election sometime next year.

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.

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



Source: RIMES, Morgan Stanley Research.

We have again 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 a renewed takeover proposal)

- **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,

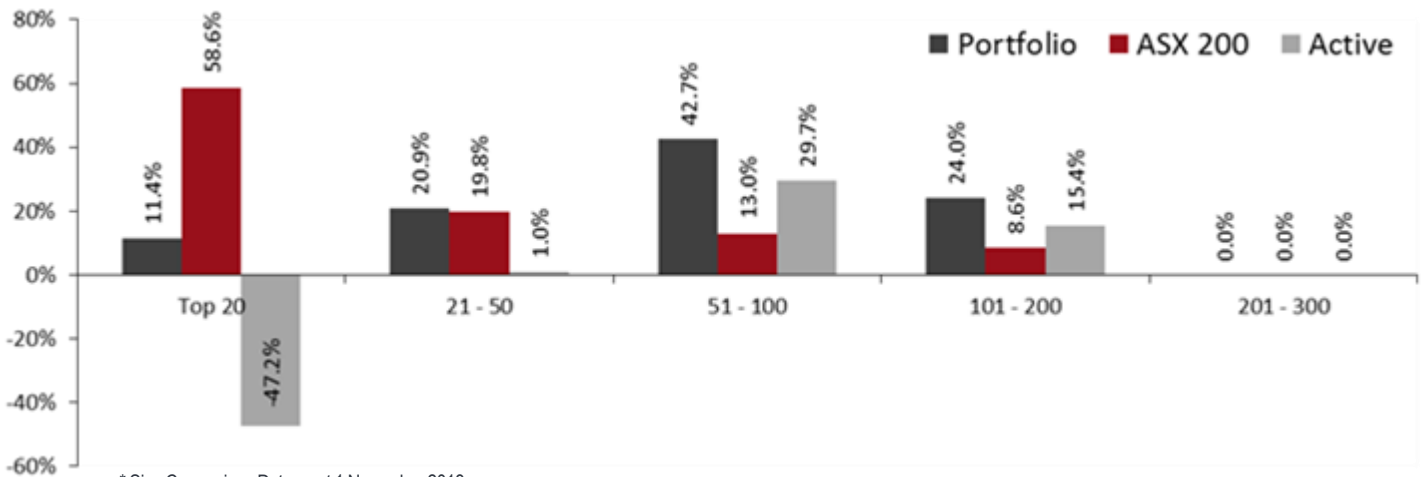


Chris Kourtis

Portfolio Manager

PORTFOLIO FEATURES

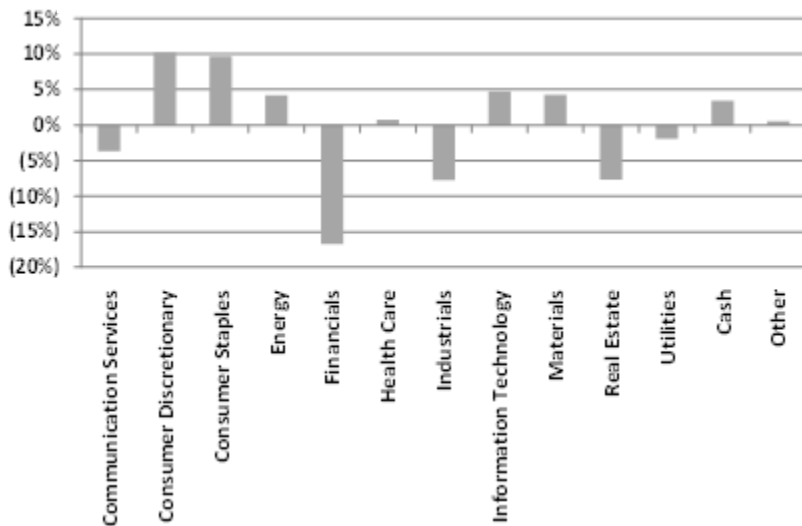
Size comparison Chart vs ASX 200



* Size Comparison Data as at 1 November 2018

Source: Bloomberg, Ellerston Capital Limited

Active Sector Exposures*



Source: Ellerston Capital Limited

* 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.

TOP 10 HOLDINGS**

BLUESCOPE STEEL
 COMPUTERSHARE
 FLETCHER BUILDING
 GRAINCORP
 HEALTHSCOPE
 JB HI-FI
 NUFARM
 ORIGIN ENERGY
 QBE INSURANCE
 TREASURY WINE ESTATES

LONG OPTION	0.0
SHORT OPTION	(15.23)
EFFECTIVE CASH	19.18
GRAND TOTAL	100%

ABOUT THE ELLERSTON OVERLAY ASF

The Fund aims to achieve its performance objectives by adopting a fundamental “bottom-up” investment approach to stock selection whilst delivering additional income where possible, through option strategies.

Because of the nature of the strategy, at least 75% of the Fund’s exposure is aligned to the portfolio of the Ellerston Australian Share Fund.

The 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.

STRATEGY FUNDS UNDER MANAGEMENT	\$224 MILLION
FUNDS UNDER MANAGEMENT –UNIT TRUST	\$27 MILLION
APPLICATION PRICE	\$1.0878
REDEMPTION PRICE	\$1.0824
NUMBER OF STOCKS	17
INCEPTION DATE	4 January 2012

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Past performance is not a reliable indicator of future performance.