ELLERSTON CAPITAL

Ellerston Global Equity Managers Fund (GEMS)

Performance Report | December 18

PERFORMANCE SUMMARY

Net %	1 Month	3 Months	1 Yr p.a.	3 Yr p.a.	5 Yr p.a.	Strategy Since Inception p.a.
GEMS C	-1.71	-11.20	-15.57	3.25	10.83	10.10

Past performance is not a reliable indicator of future performance.

MARKET COMMENTARY

Market Overview

2018 saw global stock markets close out their worst year since the global financial crisis. Investors were rattled by a combination of mounting geopolitical tensions, escalating trade tensions between the US and China and concerns of a slowing global economy, at the same time as monetary policy was tightening. It was a year that promised much, but delivered a string of disappointments, de-ratings, disagreements and likely desynchronisation. The year ended with uncertainty weighing heavily on investor sentiment and volatility on the rise. The Boxing Day bounce produced the largest one day move since 2009. In the upshot, over 90% of global risk assets were down in 2018, the highest level since 1901. As the world transitioned from quantitative easing (QE) to quantitative tightening, the brakes were slammed on the liquidity-driven rally in asset prices. December was a tumultuous month for equity markets. The MSCI World Index dropped a painful 7.2%. Surprisingly, emerging markets returned -2.9% and managed to outperform developed markets which returned -7.7%. Investors fled to traditional safe havens of gold, the Japanese Yen and US long bonds. All geographies performed badly, with some key markets in bear-market territory from their 2018 highs.

USA

The S&P 500 Index and the Dow Jones Industrial Average Index ended December down a staggering 9.0% (2018: -4.4%) and 8.6% (2018: -3.5%), respectively. The NASDAQ fared worse and fell precipitously by 9.4% (2018: -2.8%). To put this in context, the S&P 500 and the Dow recorded their worst December performance since 1931 and biggest monthly loss since February 2009. In 2018, the S&P 500 and the Dow fell for the first time in three years, while the NASDAQ broke a six-year winning streak. And the falls towards the end of the year were even more dramatic: in the last three months of the year, the S&P 500 fell 13.5%, the Dow fell 11.3% and the NASDAQ fell an astonishing 17.3%!

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 December 2009
Fund Net Asset Value	A$159.8M
Liquidity	Quarterly
Application Price	A$ 1.4271
Redemption Price	A$ 1.4200
No. Stocks	91
Gross Exposure	119%
Net Exposure	55%
Management Fee	1.50% p.a.
Buy/Sell Spread	0.25%
Performance Fee	16.50%
Firm AUM	Over A$5b

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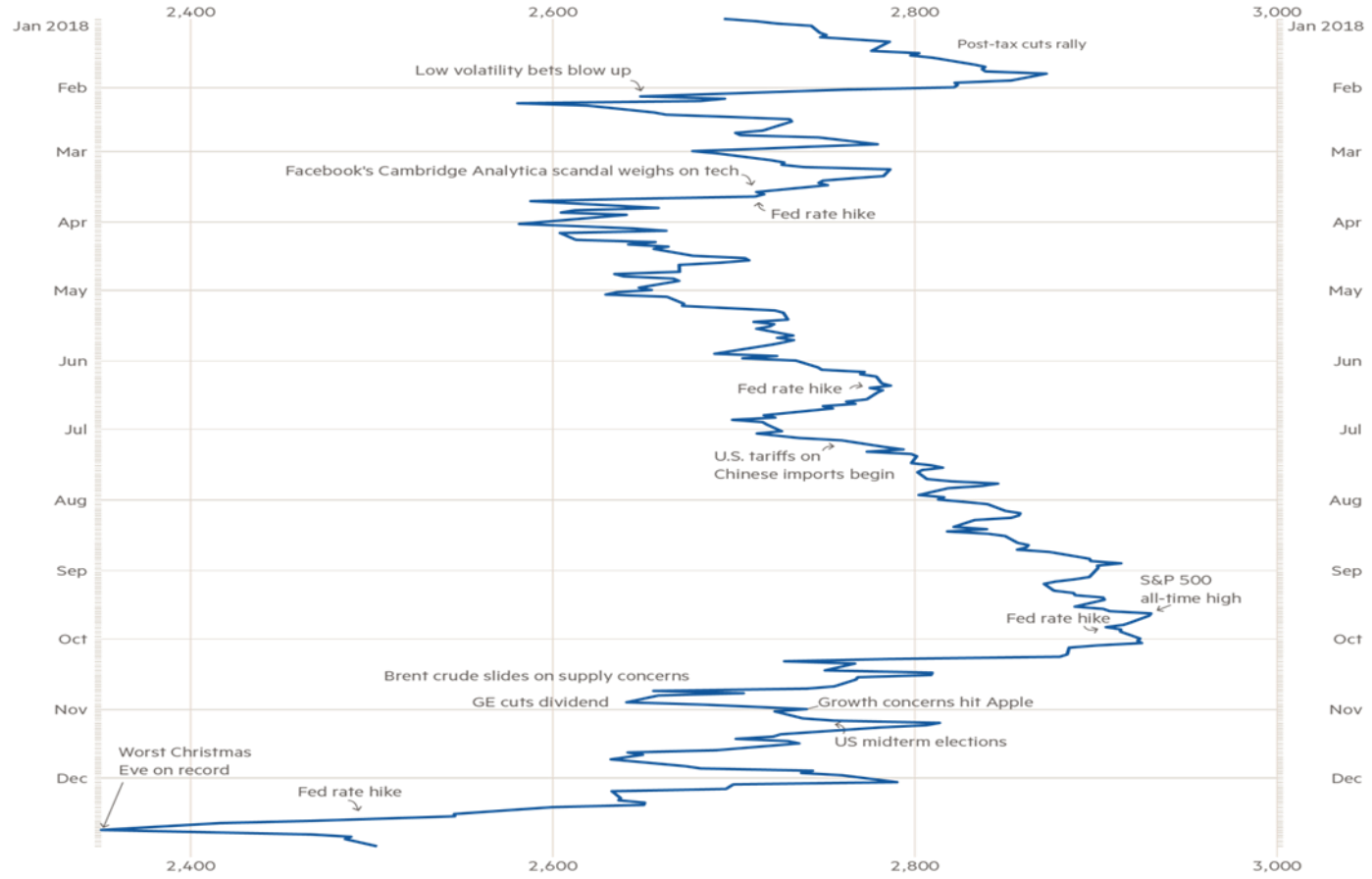
For US equities, 2018 was the worst year since the financial crisis

S&P 500 index



Source: Bloomberg, FT research
© FT

The Fed raised rates by 25 basis points as expected, moving the Fed funds rate range to 2.25-2.50%. This was despite the stock market sell-off and the illtempered "jaw boning" and constant tweeting by President Trump, including comments that he was looking to fire Fed Chairman, Powell. However, the Fed has dialled back its projections and signalled a further two hikes in 2019, down from three (indicated in September). It continues to see at least one more hike in 2020 and none in 2021. Key US economic indicators remained buoyant. Industrial production increased by 0.6% in November and ISM Manufacturing and ISM non-Manufacturing surveys increased to 59.3 (from 57.7 in October) and 60.7 (from 60.3 in October), respectively. Non-farm employment also increased by 155,000 in November, a solid number, but short of the ~200,000 per month average over the past year. The unemployment rate was unchanged at a historically low 3.7%. Investors in the US were unnerved by the ongoing trade war with China and its negative impact on global growth, with China slowing and European growth starting to cool. Also, the dampening effect of previous rate hikes and a stronger dollar are expected to bite into the domestic economy, just as the "sugar hit" of fiscal stimulus from previous tax cuts fades. And there's no clear signal that policy responses from the government will be coherent, with the White House distracted by its battle with the Democrats over funding for President Trump's wall that has resulted in a partial shut-down of government. Earnings growth expectations are being progressively culled in 2019 compared to robust earnings growth in 2018.

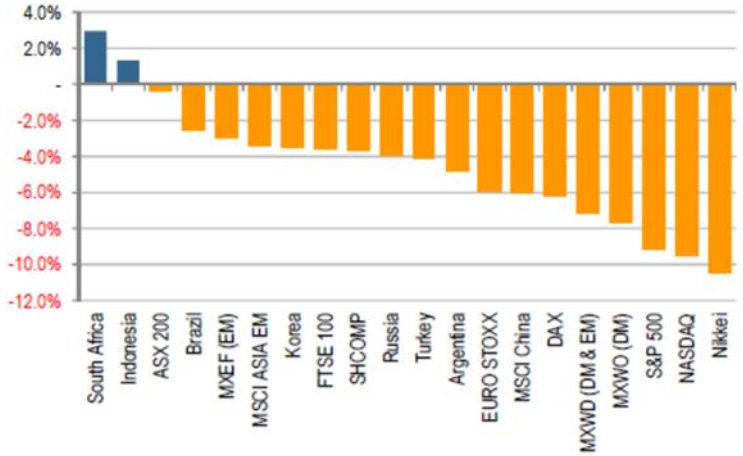
Europe

European equity markets were also sharply weaker in December, as global growth concerns weighed heavily on sentiment. The Euro STOXX 50 Index closed down 5.3% (finishing down 12.0% in the 2018 calendar year). Activity indicators in Europe were weaker again, as the Euro area composite PMI fell 1.4 points to 51.3 and consumer confidence deteriorated from -3.9 to -6.2 in December. All major European indices were in the red. The UK's FTSE 100 was down 3.5%, France's CAC 40 was down 5.2% and Germany's DAX fell 6.2%. The DAX is the worst performing major European market in 2018, with a return of -18.3%.

Asia

Asian equities were hit hard in December, with Japan bearing the brunt of slowing global growth and the aggressive withdrawal of US-dollar liquidity as the Fed tightened. The Hang Seng Index returned -2.5%, Korea's KOPSI Composite Index was down 2.7%, the Chinese market represented by the SSE Total Market Index was down 4.5% (and -21.9% in 2018), while Japan's Nikkei 225 was down 10.3%, posting its worst December in over 50 years. All the major indices except India were in negative territory for the 2018 calendar year. The Indian market's BSE SENSEX rallied 7.2% in 2018, helped by a big pull back in crude oil towards the back half of the year.

Global Equity Markets' Performance in December 2018



Source: JP Morgan, Bloomberg.

Commodities

Metal prices fell in December, with the LME Metals Index down 3.7%. Zinc was the worst performer, down 5.1%, followed by Aluminium (-4.8%), Nickel (-4.8%) and Copper (-4.5%). Tin (+6.1%) and Lead (+2.4%) bucked the trend. Brent and WTI also fell sharply yet again, down 9.7% to US$53.80 and 11.1% to US$45.41 a barrel respectively, as concerns of a supply glut and a global slowdown hurt prices. OPEC and member countries agreed to a 1.2mb/d cut, but it wasn't enough to arrest the decline. Gold prices rose +4.9% to $1,282 an ounce, as investors flocked to safe haven assets in a risk off environment.

Bonds

The US yield curve flattened in November with the spread between long-term rates and short-term rates narrowing by 7.5 basis points. The US 10-year bond yield fell 15.5 basis points to end the month at 2.99% with US 2-year bonds yields falling 8 basis points to 2.79%.

The Australian curve also flattened. The Australian 10-year bond yield fell 3.5 basis points to 2.59% and the 3-year bond yield rose 1.7 basis points to 2.01%.

Australia

Against this backdrop, the S&P/ASX 200 Accumulation Index closed the month down 0.12%, a remarkably resilient performance considering. Materials (+5.3%), Healthcare (+2.9%) and Consumer Staples (+1.5%) were the best performing sectors, while Financials (-3.1%), Communication Services (-5.1%) and Energy (-2.0%) were the worst performing sectors. In the month of December, despite slowing global Industrial Production, the ASX 200 Resources Accumulation Index was the best performer, up 5.1%. BHP Group (+11.5), led the charge, propelled by a massive capital management program, followed by Rio Tinto (+7.1%) and South32 (+8.1%). The ASX 200 Industrial Accumulation Index fell 1.4%, while the Small Ordinaries Accumulation Index was the worst performer, with a return of -4.2%. The Financials sector (-3.1%) was the single biggest detractor from the index. The sector was negatively impacted by Australia and New Zealand Banking Group (-8.7%), Westpac Banking Corporation (-3.6%), Macquarie Group (-5.0%), QBE Insurance Group (-10.8%) and National Australia Bank (-2.3%). The four major banks have again had a poor year, weighing heavily on the index's performance in calendar 2018. Please see our separate write up on the major banks.

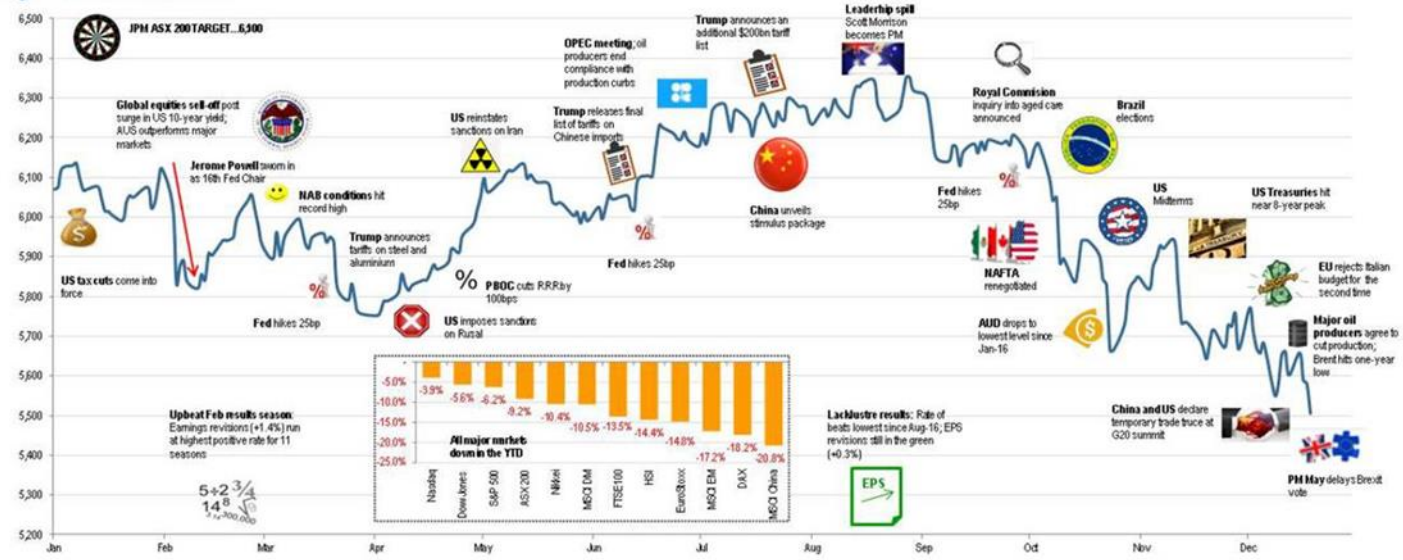
The top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were Australia and New Zealand Banking Group (-45 points), Westpac Banking Corporation (-21 points), Macquarie Group (-12 points), QBE Insurance Group (-11 points) and National Australia Bank (-10 points).

The top five stocks that added to the index's return were BHP Group (+76 points), CSL (+24 points), Commonwealth Bank of Australia (+14 points), Rio Tinto (+13 points) and Transurban Group (+9 points).

Again, the Reserve Bank of Australia kept the cash rate unchanged at 1.5% in December. 3Q18 GDP growth was a sluggish 0.3% quarter-on-quarter. Employment rose by 37,000 in November with most of the positions being part-time (+43,400), while full-time employment fell by 6,400. In trade weighted terms, the Australian dollar depreciated 4.1%, and 3.5% against the US dollar to end the month at 0.70.

The S&P/ASX 200 Accumulation Index closed the 2018 calendar year down 2.8%, the worse finish since 2011. Healthcare (+19.3%, led by CSL up 32.6%), Materials (+1.8%) and Consumer Staples (+3.8%) were the best performing sectors, while Financials (-9.7%), Communication Services (-14.1%, dragged down by Telstra) and Energy (-8.7%) were the worst performing sectors in terms of their contributions to the index. The two best performing stocks for the year were both Tech/IT related, namely application software company Bravura Solution (+119.1%) and payment services company Afterpay Touch (+107.7%). Conversely, Mozambique graphite producer Syrah was the worst performer (-66.6%), closely followed by lithium hopeful Orocobre (-53.5%).

Figure 1: 2018 Pictorial Review



Source: J.P. Morgan, Bloomberg, Microsoft Office.

Outlook and Portfolio Commentary

World markets have entered 2019 in a more fragile state than was thought likely 6 months ago. Stock markets are clearly being torn between the competing forces of fear and fundamentals that are in reasonable shape. Whilst the world economic growth outlook still looks robust, many risk assets appear to have peaked. It makes for a very volatile investment environment in 2019.

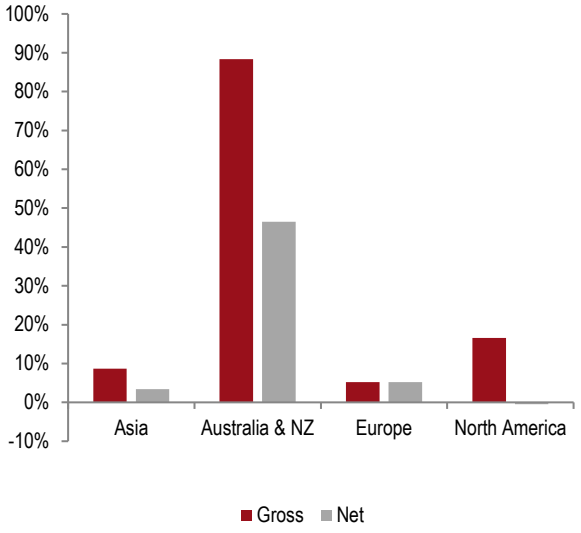
Globally, investors rightly have some major concerns including the negative effects of a trade war, slowing global growth (especially in China), coupled with sub trend growth in Europe, tighter monetary policy and more prominently, the uncertainty and incoherence, and an increasing inclination towards protectionism emanating from Trump's White House – a risk factor that the market is only now seemingly fully coming to grips with. The risk of a political miscalculation is high, especially given the precariousness of investment markets and a slowing global economy. The Fed meanwhile is concerned that QE has fuelled asset bubbles and a substantial increase in debt levels, and that it has little policy ammunition left to fight these distortions. Investors are genuinely worried over the potential for a monetary policy misstep by the Fed.

Domestically, a well-entrenched set of uncertainties continue to prevail including the second-order effects of the above macro drivers, sharply slowing credit growth, an indebted consumer, fear of a harder economic landing and a pending Federal election this year. On the positive side, we would expect more capital management initiatives as surplus franking credits are cleared and the prospect of more M&A activity if the AUD weakens further. The recent pull back in Australia's equity market has resulted in multiples for the index tracking lower, which may present buying opportunities.

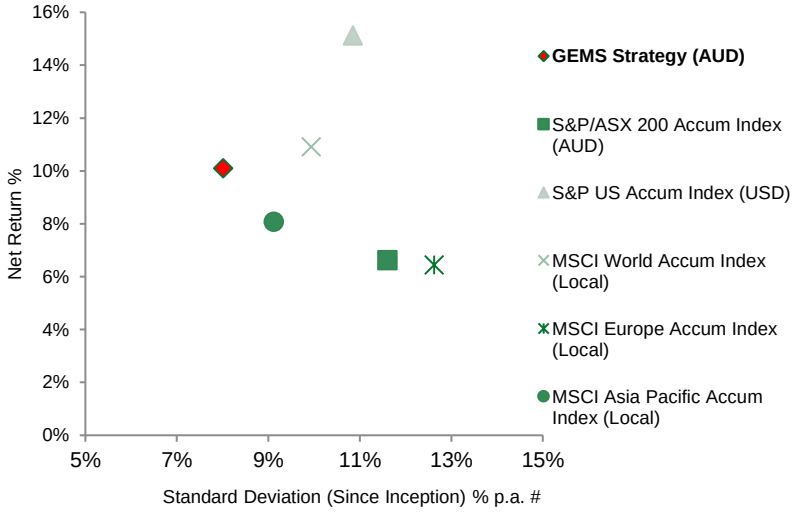
Looking forward, there is a significant chance that the "global growth scare" in 2019 is likely to come from a full blown trade war and the consumer in China spending less. The Fed's more dovish tone has seen bond yields fall sharply and this may provide a short-term fillip to risk assets to enjoy periodic relief rallies. However, concerns remain 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. In the US, the consumer looks fine, but trade tariffs are starting to impact the outlook for corporates when sifting through the recent commentary from executives.

Against this tumultuous backdrop, during December, we have brought down the gross long exposure of the portfolio significantly, from 108% to 87%, mainly through decreasing exposure to the US and Australia/ New Zealand. We have also marginally decreased our gross short exposure (from 34% to 32%) in Australia/ New Zealand and Asia, while added gross short exposure in the US. In terms of sectors, the reduction in long exposures came primarily from the consumer discretionary, information technology and energy sectors, whilst our decreases in short exposure were dispersed across a range of sectors. We increased our hedges accordingly. The aggregate result is a significantly lower level of total gross exposure for the portfolio (from 142% to 119%) as well as a much lower total net exposure (from 73% to 55%).

Market Exposure as a % of NAV



GEMS Strategy Performance & Volatility ^



Top Holdings (Alphabetical, Long only)

- ALPHABET
- BP
- CLOVER CORP
- ECLIPX GROUP LTD
- EZCORP
- GRAINCORP
- HEALTHSCOPE
- NEWCREST MINING
- NUFARM
- PSC INSURANCE

Source: Ellerston Capital

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

Material Matters

During the month there were no material changes that would impact the Fund in terms of its risk profile, investment strategy or investment staff. 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.

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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.