ELLERSTON CAPITAL

Ellerston Australian Market Neutral Fund

Performance Report | December 18

FUND PERFORMANCE (%)

	1 Month	3 Months	6 Months	1 Year	3 Years p.a.	5 Years p.a.	Since Inception p.a.
Fund Net	-2.54	-6.86	-11.07	-11.30	-1.15	4.57	5.91
RBA Cash Rate	0.13	0.38	0.75	1.50	1.57	1.87	1.94
Alpha	-2.67	-7.24	-11.82	-12.80	-2.72	2.70	3.97

Source: Ellerston Capital Limited

	Jan	Feb	Mar	April	May	June	July	Aug	Sep	Oct	Nov	Dec	YTD
2018	-0.03	0.54	-0.34	-1.19	-0.28	1.05	-2.78	-0.99	-0.80	-2.60	-1.89	-2.54	-11.30
2017	0.54	-0.98	0.47	-0.01	-0.57	1.64	-0.40	0.87	0.12	1.09	-0.20	2.14	4.76
2016	-0.97	-1.03	0.80	0.10	1.34	0.55	0.71	1.93	0.73	-0.53	0.29	0.02	3.96
2015	-0.15	1.09	1.41	1.04	-0.11	1.29	0.71	1.11	0.88	0.59	1.37	1.09	10.81
2014	2.50	0.33	0.93	-0.47	2.31	3.60	1.24	2.42	3.16	-0.82	1.53	-0.95	16.82
2013						0.48	1.12	1.74	1.38	2.87	-0.34	2.54	10.18

The net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance. The benchmark is the RBA Cash Rate.
Source: Ellerston Capital Limited

PORTFOLIO METRICS

Positive months	66%	Net Equity Exposure	+24.0%
No. Relative Value positions	95	Gross Portfolio Exposure	151.3%
No. Special Situations	26	Correlation Coefficient (vs ASX 200 Accum)	4.67%
Beta Adjusted	0.6%	Net Sharpe Ratio (RFR = RBA Cash)	0.88

Investment Objective

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

Investment Strategy

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

Key Information

Strategy Inception Date	3 June 2013
Fund Net Asset Value	$476.8M
Liquidity	Daily
Application Price	$0.9865
Redemption Price	$0.9815
Management Fee	1.20%
Buy/Sell Spread	0.25%
Performance Fee	20% of outperformance
Firm AUM	Over $5 billion

PERFORMANCE

Market conditions continued to hamper performance during December, with the Fund declining in value by 2.5% in the period. There were no real winners within Relative Value, with the strategy contributing -1.5% (gross) to the Fund's return. Within Special Situations, Johns Lyng (+29.3%) was the standout, however the strategy still contributed a gross return of -0.9% in the month.

Gross exposure once again increased modestly in the period, closing the month at 151% (from 145% at the end of November). Net exposure was +24% with a beta-adjusted net of +0.6%.

Our paired position between Village Roadshow (+10.6%) and Ardent Leisure (-1.0%) was the largest positive contributor within Relative Value in the period. Favourable Gold Coast weather conditions, coupled with a stronger-than-expected box office during the first half, resulted in modest upgrades to consensus earnings for Village. In addition, for the second time in 12 months, Village increased its theme park ticket prices, suggesting that its Theme Park division continues to trade well. Despite the recent rally in the Village share price, the stock trades at an FY19 EV/EBITDA multiple of just 6.2x, compared with Ardent which trades at 10.6x.

The spread between the Australian and UK listings of BHP Billiton (+11.5%) and Rio Tinto (+7.1%) narrowed in the month, adding to the performance of the Fund.

BWP Trust (+3.6%) continued to outperform in December, despite increasing headwinds including exposure to the residential housing market and falling occupancy. A paired position in which we hold a long in Peet (-7.1%), hedged with a short in BWP Trust, detracted from the performance of the Fund.

Paired positions that featured a long position in Ingenia Communities (-2.0%) generally struggled in the month, with the stock underperforming most of its peers following last month's share placement to Sun Communities (-1.6%). The placement left Sun Communities with 9.99% of Ingenia, but with the ability to increase on market (to 13.4%) any time after February 7th. We met with Sun Communities management during December and were impressed with their track record in North America and their plans for the Australian Manufactured Housing Estate industry. Their A$100m investment in Australia remains relatively modest (given Sun's market cap is over A$12b) and we think they have intentions to increase their investment over time.

Johns Lyng was the largest contributor to Special Situations in the month, with the share price benefitting from the hailstorms across the Sydney, Central Coast and South East Queensland regions in late December. As a major provider of building and restoration services to the insurance industry, Johns Lyng's workload (and revenue) increases dramatically following catastrophic events such as the December hailstorms. Whilst their occurrence is difficult to predict, catastrophic events can be a windfall for Johns Lyng as the urgency of restoration normally lends itself to higher margins in the period. The hailstorms are expected to provide at least a year's additional work for the Insurance Building and Restoration Services division, with earnings during the CY19 expected to be higher accordingly.

Other than Johns Lyng, there were little highlights within Special Situations during December. The share price of medical-device-company ImpediMed (-25.5%) continued to fall with OneMarket (-27.8%), Superloop (-9.3%) and Catapult (-24.1%) all suffering the same fate with no new news.

ACTIVITY

Relative Value – Gross Contribution -1.51%

We unwound the paired position between building material companies Fletcher Building (+4.0%) and Adelaide Brighton (-17.6%) during the month. Following on from Fletcher Building downgrading their FY19 guidance in November, Adelaide Brighton also downgraded in early December, with the company now expecting NPAT to be 6.6% lower than previous guidance. The market was unimpressed and sold the stock down heavily following the release. Fletcher Building had a better month, with the company announcing the sale of Formica for NZ$1,226 million and their intention to reinstate the payment of dividends in FY19.

Three REITs announced acquisitions during the month, with Cromwell Property (+1.8%), Centuria Industrial (-1.0%) and the Charter Hall Long WALE REIT (+5.7%) all raising equity to fund their purchases. Firstly, Cromwell held a 2-for-13 entitlement issue with the bulk of the proceeds used to fund their equity commitment to the Cromwell European REIT, which itself raised equity in November. Centuria Industrial was next, with a 1 for 13.5 non-renounceable rights issue to fund $54.4m of industrial acquisitions. Finally, the Charter Hall Long WALE REIT acquired a portfolio of chicken processing facilities, raising $125m to partly fund the purchase. We participated in all three placements, creating new pairs and hedging the exposure with various other REITs.

We increased our exposure to our rural-services pair, adding to the long holding in Ruralco (+0.0%) and hedging the exposure with Elders (+4.4%). There was corporate activity in the rural-services sector during December with GrainCorp (+25.6%) the subject of a non-binding, indicative proposal from Long-Term Asset Partners (an asset manager whose beneficiaries are Australian investors). The proposal was struck at an eye-watering 43% premium to the last price of GrainCorp, a level that we think warrants serious consideration by the GrainCorp board. We continue to believe there are other opportunities for consolidation within rural-services and continue to hold a long position in PGG Wrightson (-10.5%) within Special Situations, in addition to the Ruralco-Elders pair.

We established and unwound a paired positions between Contact Energy (+0.5%) and Meridian Energy (+3.0%) in the period. High average electricity prices benefited the sector in the second half of 2018, although strong south island inflows eased prices for southern generators in the lead into Christmas. We gained confidence in Contacts medium-term strategy post their investor day in November, where they highlighted the various expansions options for their Wairakei geothermal field. Despite having a flat upside to consensus target price, we prefer Contact over the lower yielding Meridian, which consensus is forecasting to fall by ~11% over the next 12 months. We also established and unwound paired positions between AusNet Service (+0.6%) and Spark Infrastructure (-6.0%), and between Abacas Property Group (+6.0%) and National Storage (+3.7%), both on valuation grounds.

Special Situations – Gross Contribution -0.92%

We added to our Healthscope (-1.3%) holding during the month, with the stock trading circa 10% below the bid price. During the period, Brookfield announced that they had received substantially all the due diligence materials that were requested from Healthscope and that it has no reason to believe it would not be willing and able to proceed with the proposal to acquire the company at the previously announced level. Brookfield and Healthscope also agreed to extend the exclusivity provisions to 18 January 2019. We expect that the deal will close in the 2H FY19, following all the necessary regulatory approvals.

We also established a long position in Eclipx Group (+0.3%), hedged with a short in McMillan Shakespeare (-1.7%) at the announced merger ratio. In November, the companies announced that they proposed to merge, with Eclipx shareholders receiving scrip in McMillan Shakespeare, in addition to a cash consideration of $0.46 per share. Both company boards have recommended that the merger be supported by shareholders, with the deal expected to close in March.

Our position in Johns Lyng was increased during December, with a large institutional seller finally clearing the last of their shareholding. As mentioned earlier, the share price benefitted from the December hailstorm that effected Sydney and SE Queensland.

Our exposure was reduced to Special Situations including IVE Group (+0.5%), Redbubble (-22.7%), Paragon Care (+0.8%) and Pro-Pac Packaging (-7.0%) and we completely exited our position in Turners Automotive Group (-5.2%).

SECTOR ALLOCATION

Sector	Long Equity	Short Equity	Net Equity
Banks	0.0%	0.0%	0.0%
Div Financials	0.0%	0.0%	0.0%
Insurance	0.0%	0.0%	0.0%
Regional Banks	0.0%	0.0%	0.0%
REITs	45.7%	-35.2%	10.5%
Financials	45.7%	-35.2%	10.5%
Builders	1.5%	0.0%	1.5%
Consumer Disc	3.7%	0.0%	3.7%
Consumer Staples	3.4%	-1.1%	2.3%
Contractors	0.0%	0.0%	0.0%
Gaming	0.0%	0.0%	0.0%
General Industrials	2.5%	-0.5%	2.0%
Health Care	4.0%	0.0%	4.0%
Information Technology	1.1%	0.0%	1.1%
Infrastructure	0.0%	0.0%	0.0%
Materials	0.0%	0.0%	0.0%
Media	2.9%	0.0%	2.9%
Telcos	0.0%	0.0%	0.0%
Utilities	3.0%	-0.6%	2.5%
Industrials	22.2%	-2.2%	20.0%
Bulk Metals	16.9%	-16.9%	0.0%
Energy	0.3%	0.0%	0.3%
Gold	0.0%	0.0%	0.0%
Resources	17.2%	-16.9%	0.3%
Hedge	0.0%	-6.9%	-6.9%
Index	0.0%	-6.9%	-6.9%
Total	85.1%	-61.2%	24.0%

Source: Ellerston Capital Limited

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 de-synchronisation. 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.

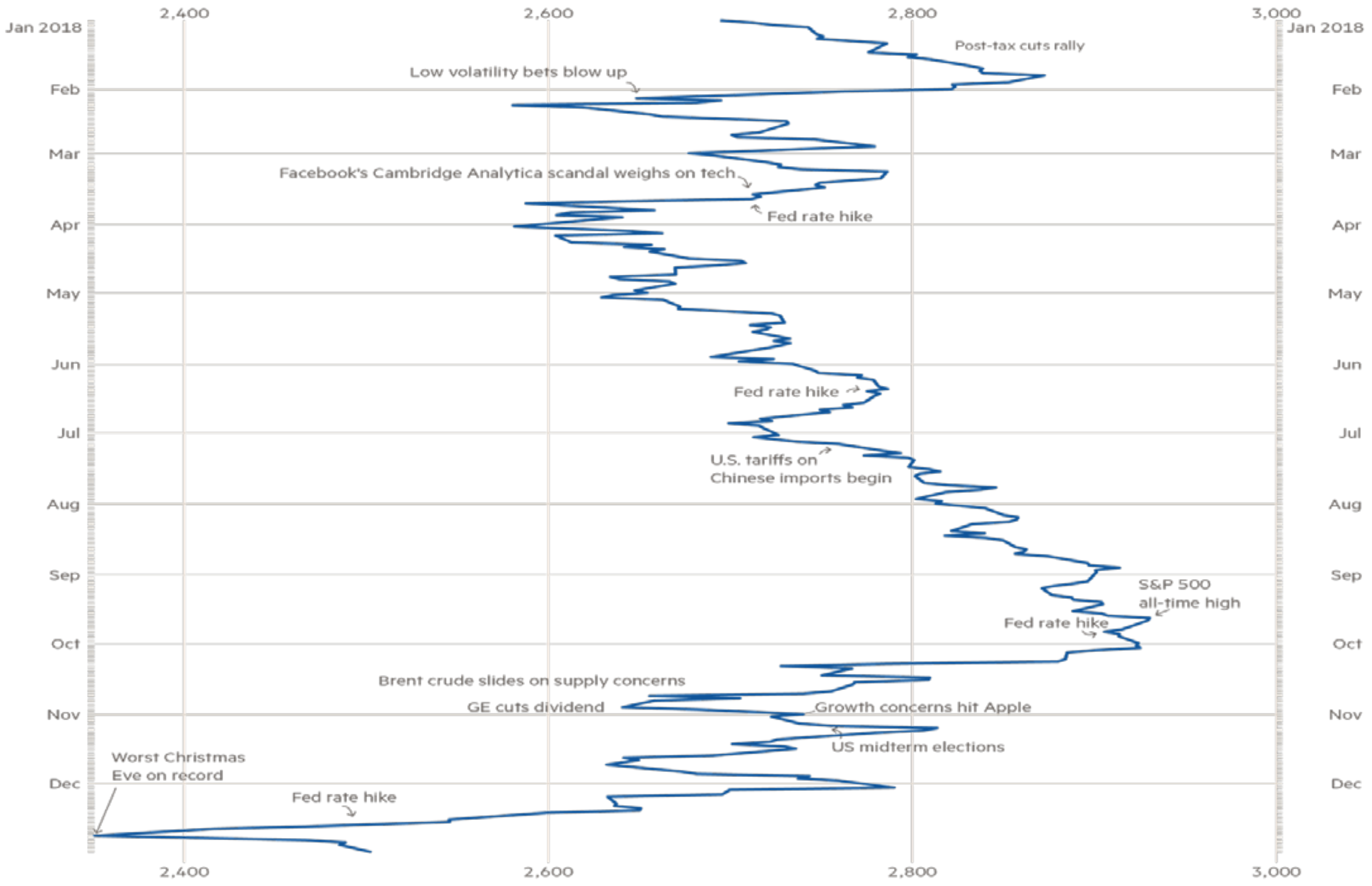
December was a tumultuous month for equity markets. The MSCI World Index dropped a painful 7.2%. Surprisingly, emerging markets returned -2.9% and managed to outperform developed markets which returned -7.7%. Investors fled to traditional safe havens of gold, the Japanese Yen and US long bonds. All geographies 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%!

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 ill-tempered "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

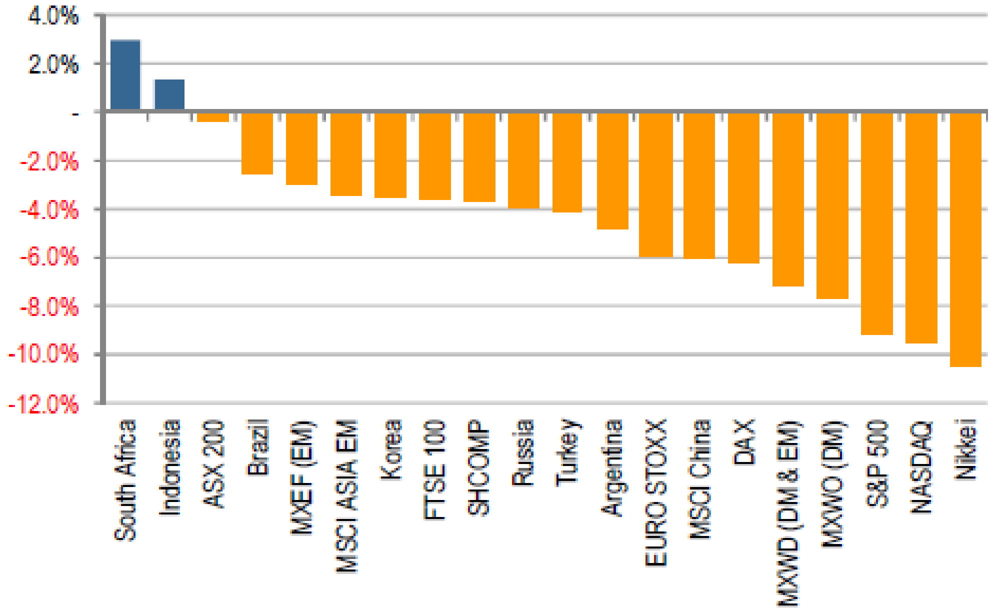
European equity markets were also sharply weaker in December, as global growth concerns weighed heavily on sentiment. The Euro STOXX 50 Index closed down 5.3% (finishing down 12.0% in the 2018 calendar year). Activity indicators in Europe were weaker again, as the Euro area composite PMI fell 1.4 points 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

Investors also rushed back to bonds.

The US yield curve flattened further in December with the spread between long-term rates and short-term rates narrowing by 50 basis points. The US 10-year bond yield fell 30.4 basis points to end the month at 2.68%, with US 2-year bonds yields falling 29.9 basis points to 2.49%. As the curve continues to flatten, fears it may invert continue to build, as this usually portends a recession.

The Australian curve also flattened. The Australian 10-year bond yield fell 27.4 basis points to 2.32% and the 3-year bond yield fell 16.1 basis points to 1.85%.

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).

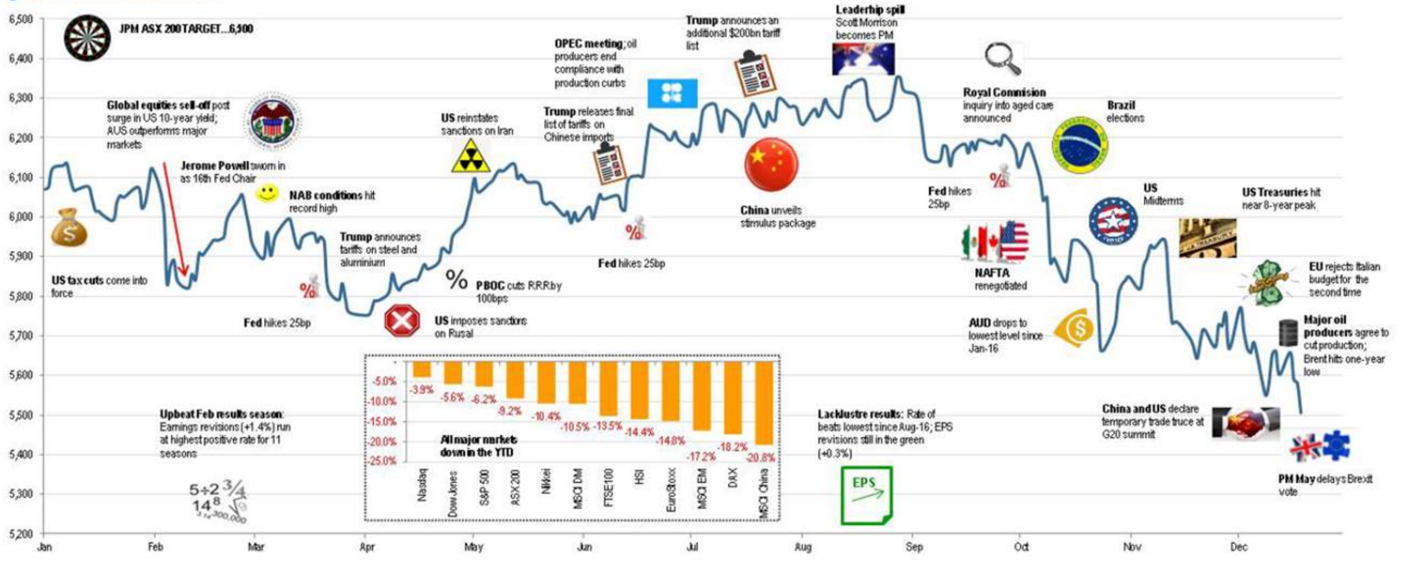
The top five stocks that added to the index's return were BHP Group (+76 points), CSL (+24 points), Commonwealth Bank of Australia (+14 points), Rio Tinto (+13 points) and Transurban Group (+9 points).

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.

CONTRIBUTION

Relative Value Gross Contribution -1.51%

Positive		Negative	
ARDENT LEISURE GROUP - VILLAGE ROADSHOW	0.21%	OOH!MEDIA - QMS MEDIA	-0.25%
BHP BILLITON - BHP BILLITON	0.20%	CHARTER HALL RETAIL REIT - PEET	-0.18%
RIO TINTO - RIO TINTO	0.10%	BWP TRUST - PEET	-0.18%
ELANOR RETAIL PROPERTY FUND - SHOPPING CENTRES AUSTRALASIA	0.06%	BWP TRUST - CARINDALE PROPERTY TRUST	-0.15%
CHARTER HALL LONG WALE REIT - GROWTHPOINT PROPERTIES	0.05%	GROWTHPOINT PROPERTIES - INGENIA COMMUNITIES GROUP	-0.14%

Special Situations Gross Contribution -0.92%

Positive		Negative	
JOHNS LYNG GROUP LTD	0.35%	IMPEDIMED LTD	-0.25%
UNIBAIL-RODAMCO-WTFEILD-DCI	0.03%	ONEMARKET LTD	-0.23%
ECLIPX GROUP LTD	0.02%	SUPERLOOP LIMITED	-0.16%
PROPERTYLINK GROUP	0.01%	CATAPULT GROUP INTERNATIONAL	-0.14%
IVE GROUP LTD	0.01%	REDBUBBLE LTD	-0.13%

Source: Ellerston Capital Limited

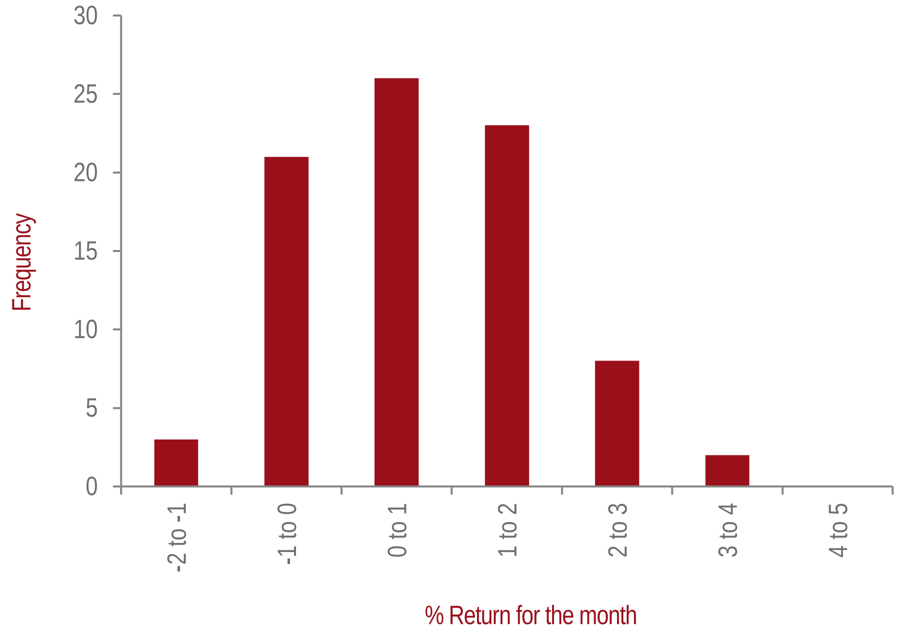
TOP 10 RELATIVE VALUE POSITIONS

- BHP BILLITON - BHP BILLITON
- RIO TINTO - RIO TINTO
- CENTURIA CAPITAL - DEXUS PROPERTY GROUP
- AUSTRALIAN UNITY INVESTMENT REAL ESTATE - NATIONAL STORAGE REIT
- CENTURIA CAPITAL - GPT GROUP
- ELANOR RETAIL PROPERTY FUND - SHOPPING CENTRES AUSTRALASIA
- GROWTHPOINT PROPERTIES - INGENIA COMMUNITIES GROUP
- CENTURIA METROPOLITAN REIT - NATIONAL STORAGE REIT
- BWP TRUST - CARINDALE PROPERTY TRUST
- BWP TRUST - CENTURIA CAPITAL

TOP 10 SPECIAL SITUATION POSITIONS

- S&P/ASX 200 INDEX PUT OPTIONS
- NUFARM FINANCE NZ LTD
- HEALTHSCOPE LTD
- INFIGEN ENERGY
- IVE GROUP LTD
- SUPERLOOP LIMITED
- JOHNS LYNG GROUP LTD
- SUNCORP GROUP NOTE
- IMPEDIMED LTD
- PRO-PAC PACKAGING LTD

DISTRIBUTION OF NET RETURNS



Source: Ellerston Capital Limited

Key Service Providers

Registry: Link Market Services Limited

Auditor: Ernst & Young

Prime Broker & Derivative Counterparty:

Morgan Stanley Intl & Co PLC

Goldman Sachs International

Administrator: State Street Australia Limited

Material Matters

During the month there were no material changes to the Fund in terms of its risk profile, investment strategy or changes to investment staff which would impact this strategy. There have been no changes to the key service providers described above.

For further information, please contact:

Retail Distribution

Andrew Seddon
0417 249 577
aseddon@ellerstoncapital.com

Simon Glazier
0410 452 949
sglazier@ellerstoncapital.com

Institutional Distribution

Melinda Carter
0439 173 040
mcarter@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