Ellerston Australian Market Neutral Fund

Performance Report | November 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	-1.89	-5.20	-7.80	-7.05	0.06	5.64	6.50
RBA Cash Rate	0.12	0.37	0.76	1.50	1.59	1.88	1.95
Alpha	-2.01	-5.57	-8.56	-8.55	-1.53	3.76	4.55

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		-9.00
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	67%	Net Equity Exposure	+24.9%
No. Relative Value positions	102	Gross Portfolio Exposure	145.2%
No. Special Situations	28	Correlation Coefficient (vs ASX 200 Accum)	4.01%
Beta Adjusted	9.1%	Net Sharpe Ratio (RFR = RBA Cash)	1.04

PERFORMANCE

The Fund had another difficult month in November, returning -1.9% (net) versus the benchmark's return of +0.1%. The contribution from Relative Value was flat in the period, with Special Situations entirely responsible for the negative performance. The equity market continues to be driven by liquidity rather than fundamentals: an environment that is proving incredibly difficult to navigate.

Our gross exposure increased modestly in the period, closing the month at 145% (from 137% at the end of October). Net exposure at the end of November was +24.9% with a beta-adjusted net of +9.1%.

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	$510.9M
Liquidity	Daily
Application Price	$1.0121
Redemption Price	$1.0071
Management Fee	1.20%
Buy/Sell Spread	0.25%
Performance Fee	20% of outperformance
Firm AUM	Over $5 billion

During the month, Ingenia Communities (+6.3%) announced the placement of 23m shares to Sun Communities (+3.6%) at a 14% premium to the prevailing market price, raising approximately $74.6m. The placement leaves Sun with a 9.99% stake in Ingenia, with the ability to move to 13.4% following a three month standstill agreement (by purchasing additional shares on market). The two companies have also formed a Strategic Partnership, which will jointly invest in the development of Australian green-field lifestyle communities. The announcement was well received, with the introduction of a capital partner expected to improve the growth profile for Ingenia. We have been a fan of the Manufactured Housing Estate sector for a long time and paired positions that feature a long in Ingenia added to the performance of the Fund during November.

Both Ruralco (+7.6%) and Elders (-6.2%) reported in the period, with our paired position between the two companies adding value. Despite challenging conditions, Ruralco reported full-year NPAT growth of 10%, a commendable performance given the rural environment. Shareholders are beginning to see the benefits of the move into Water Services, which saw profit grow 80% in the year, due to the prevailing dry conditions. Elders also reported NPAT growth of 10%, but is far more expensive, trading an FY19 EV/EBITDA multiple of 10.9x compared with Ruralco at 6.2x.

We continue to be frustrated by the performance of a number of short positions where share prices continue to defy fundamentals. For example, BWP Trust (+0.9%), which owns a number of Bunnings Warehouse properties, trades at a premium to NTA of 22.4% and pays an unfranked yield of 5.2%, despite not having the cash earnings to cover their dividend (they top the dividend up with capital profits). Sell-side analysts have a negative outlook on the stock, with zero buy recommendations, two neutrals, five sells, and an expected Total Shareholder Return (TSR) of -14.3%. Similarly, Charter Hall Retail (+6.4%) continues to defy gravity, despite almost no growth in earnings, an unfranked yield of 6.4% and trading at a premium to NTA of 6.3%. Sell-side analysts are also negative, with zero buys, five holds, five sells, and an expected TSR of -10.0%.

Within Australian REITs, we currently see extremely high levels of mispricing and this translates to a wide spread between the valuation of longs and shorts within the Fund. The average premium to NTA of our longs (+6.5%) is currently at the largest discount to that of our shorts (+27.0%), since the inception of the Fund.

Both Village Roadshow (+7.9%) and Ardent Leisure (-6.9%) held their AGMs during the month with our paired position between the two companies adding value. The market was impressed by the commentary from Village that suggested Gold Coast Theme Parks were trading ahead of expectations, whilst Cinemas were ahead of last year. Following the AGM, there were modest upgrades to consensus earnings. Conversely, at the Ardent AGM, the company announced increased capex at Dreamworld and indicated that sales momentum at Main Event was slowing, resulting in analyst downgrades to FY19 earnings.

The share price of Centuria Capital (+0.8%) underperformed its property peers during November, detracting from the performance of the Fund. It feels like the market is struggling to digest last month's capital raise, with the share price seemingly anchored to the placement price of $1.30. Despite the recent share price performance, the fundamentals for Centuria remain strong, with both Centuria Metropolitan (+1.3%) and Centuria Industrial (+1.8%) growing AUM, and a large gain expected on the divestment of the Propertylink (+0.9%) stake. Both sell-side analysts that cover Centuria have buy recommendations, with a forecast TSR of over 20%.

The spread between the Australian and UK listings of BHP Billiton (-4.7%) and Rio Tinto (-4.1%) widened in the month, detracting from the performance of the Fund.

As previously mentioned, Special Situations struggled during November, with a number of stocks trading down aggressively and no real winners. Medical-device company ImpediMed (-36.3%) was the largest detractor, with a substantial shareholder rumoured to be liquidating their position during the month. There was no news on the company in the period.

Our shareholding in Australian Unity Office (-2.1%) also detracted from the performance of the Fund, with Starwood Capital reducing their offer for the REIT following a period of due diligence. Starwood revised their cash offer from $2.95 to $2.87, a revision that the independent board committee considered material and hence withdrew their support. The new offer was a surprise, especially considering that Starwood had confirmed there was nothing that had emerged during their due diligence.

ACTIVITY

Relative Value – Gross Contribution -0.02%

We reintroduced a long position in Fletcher Building (-19.7%), once again hedging the exposure with a short in Adelaide Brighton (-8.6%). During the month, Fletcher Building downgraded FY19 guidance, with the company now expecting EBIT to be approximately 5% lower than consensus estimates. Further, it flagged that 1H19 EBIT was likely to be approximately 10% lower than the prior corresponding period, with the key reasons being an outage at Golden Bay Cement, a slowdown in the Australian residential market, and the timing of sales in the NZ residential business. The stock was sold down aggressively following the downgrade and now trades on an FY19 PE of just 10.5x – 33% lower than Adelaide Brighton.

Ahead of their AGM, we unwound all our remaining pairs that featured a long position in Aveo (-7.9%). Despite the ongoing strategic review, we recognise that there are a number of headwinds facing the company, including a slowing residential market and the potential of being drawn into the aged care royal commission. Given these headwinds, and despite trading at a material discount to NTA, we felt that it was prudent to cut the exposure and move on.

We added to our position in the Rio Tinto (-4.1%) Ltd-Plc spread in November, capitalising on a spike in the share price of Rio Tinto Ltd following the completion of the off-market buyback. During the period, Rio Tinto announced they had purchased $2.9b worth of Ltd shares, at a 14% discount to the market price. The scale back was lower than the market expected, with the resultant scramble for shares leading to the spike.

Following a narrowing in the spreads, we unwound paired positions between Capitol Health (+1.8%) and Integral Diagnostics (+3.7%), Arena REIT (+10.6%) and Charter Hall Education (+1.8%), and Rural Funds (+1.9%) and Growthpoint Properties (+0.8%).

Special Situations – Gross Contribution -1.76%

We took part in an equity placement in Redbubble (-25.1%) during the month, with the funds used for the acquisition of TeePublic, a rival online commerce marketplace. Late in the month, the company provided an update on its sales performance over the Thanksgiving weekend and the results were disappointing. Sales were negatively impacted by two Google algorithm changes which occurred in September and early October. Whilst the impact is expected to be short-term, the market was unimpressed and the stock was sold down heavily.

Healthscope (+7.1%) announced that it had received an approach from Brookfield Capital Partners to acquire 100% of Healthscope by way of a scheme of arrangement at $2.55 and a parallel off-market takeover offer at $2.42 (which seeks at least 50.1% of the register). Brookfield were granted exclusive due diligence by the board, with the expectation that a firm bid will be lodged by the end of the year. Following the announcement, we established a modest long position in Healthscope, with the expectation that we will build on the position as conditions to the bid are achieved.

SECTOR ALLOCATION

Sector	Long Equity	Short Equity	Net Equity
Banks	0.3%	0.0%	0.3%
Div Financials	0.0%	0.0%	0.0%
Insurance	0.2%	0.0%	0.2%
Regional Banks	0.0%	0.0%	0.0%
REITs	46.6%	-37.2%	9.4%
Financials	47.1%	-37.2%	9.9%
Builders	1.4%	-0.3%	1.1%
Consumer Disc	3.9%	-0.1%	3.7%
Consumer Staples	0.6%	-1.2%	-0.5%
Contractors	0.8%	0.0%	0.8%
Gaming	0.0%	0.0%	0.0%
General Industrials	2.4%	0.0%	2.4%
Health Care	3.8%	0.0%	3.8%
Information Technology	1.4%	0.0%	1.4%
Infrastructure	0.0%	0.0%	0.0%
Materials	0.0%	0.0%	0.0%
Media	4.9%	0.0%	4.9%
Telcos	0.0%	0.0%	0.0%
Utilities	3.5%	0.0%	3.5%
Industrials	22.6%	-1.6%	21.0%
Bulk Metals	12.7%	-12.8%	-0.1%
Energy	0.3%	0.0%	0.3%
Gold	0.0%	0.0%	0.0%
Resources	13.0%	-12.8%	0.2%
Hedge	0.0%	-6.2%	-6.2%
Index	0.0%	-6.2%	-6.2%
Total	82.7%	-57.8%	24.9%

Source: Ellerston Capital Limited

MARKET COMMENTARY

Market Overview

After tumbling in October, equity markets delivered mixed performances in November. The US and Asian markets were in the black, but Europe and Australia (the worst performing major index) ended the month lower. Overall, emerging markets outperformed developed markets for the first time in eight months. Towards the end of the month, Fed Chairman Powell noted that interest rates "remain just below the broad range of estimates of the level that would be neutral". The market interpreted this as a signal that the brakes were going to be applied to further Fed rates hikes. This dovish sign allowed risk assets to rally, with global bonds yields falling after rising in the early part of the month. The Fed signalling a softer stance on rates, a fall in inflationary expectations and a sharp decline in oil prices were all reasons proffered for the rally in global bonds. All eyes were on the Trump-Xi meeting post the G20 summit in early December, for any direction on the trade war between the US and China that has been threatening global growth prospects.

USA

The S&P 500 Index and the Dow Jones Industrial Average Index ended November up 2.0% and 2.1%, respectively. The NASDAQ delivered more modest returns, finishing the period higher by 0.5%.

While the Fed kept policy rates at the 2.0% to 2.25% target range, it flagged a less aggressive stance on increasing interest rates. Coupled with the expectations of a rapprochement between the US and China on trade, markets moved back into a risk-on frame of mind. Investors had been on edge that signs of slowing growth were likely to hamper corporate profits, and this could be exacerbated by rising rates. Following Powell's more accommodative comments, technology stocks that bore the brunt of the six-week sell-off led the rebound.

In October, US activity indicators softened, but remained at solid levels. The manufacturing ISM retraced to 57.7 (consensus: 59.0, previous: 59.8) while the composite non-manufacturing ISM fell less than expected to 60.3 (consensus: 59.0, previous: 61.6). Non-farm payrolls beat expectations, rising 250k in October (consensus: +200k, previous: +118k) while the unemployment rate held at 3.7%, a 30 year low.

Early in the month, the 2018 US mid-terms saw the Democrats win control of the House, but in the Senate the Republicans increased their majority. The change in the political balance was not expected to have any material impact on the underlying economy. Post the G20 summit in early December, the US agreed to a three-month hiatus on imposing further tariffs on Chinese goods, so the two sides could find a way to ease tensions in the ongoing trade war.

Europe

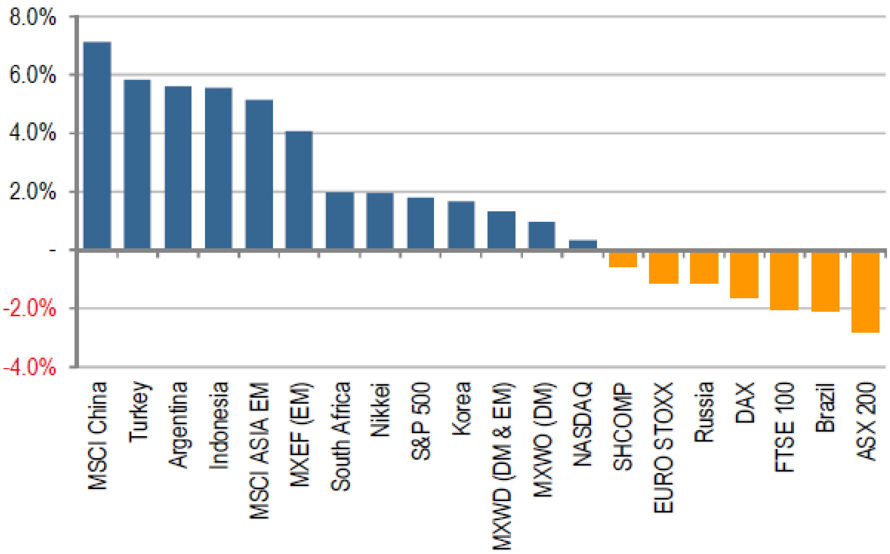
European equity markets were weaker again, as Italian budget concerns and Brexit weighed heavily on sentiment. The Euro STOXX 50 Index closed down 0.7% and is now down 7.1% calendar year to date. Activity indicators in Europe continued to weaken. The flash Eurozone manufacturing PMI for November missed expectations and fell to 51.5 (consensus: 52.0, previous: 52.0), while the composite PMI was also lower at 52.4 (consensus: 53.0, previous: 53.1).

The UK's FTSE 100 was down 1.6% and the GBP came under renewed pressure (given ongoing Brexit uncertainty and despite Prime Minister May securing a deal on withdrawing from the EU). The French market, the CAC 40, was down 1.7% with Germany's DAX falling by the same amount.

Asia

Asian equities bounced in November. Investors bought into markets that looked oversold after the brutal sell-off in October and were betting that the Fed's less aggressive stance and some abating in trade pressures would support underlying fundamentals. The Hang Seng Index returned +6.2%, the BSE Sensex was up 5.2%, while Japan's Nikkei 225 returned just under 2.0% and Korea's KOSPI Composite Index was up 3.3% (after being the worst performer last month).

Global Equity Markets' Performance in November 2018



Source: JP Morgan, Bloomberg.

Commodities

Metals recovered in November, with the LME Metals Index up 1.9%. Brent and WTI also fell sharply again, down 20.8% to US$59.46 and 22.2% to US$50.93 a barrel respectively. Iron ore prices also slipped, down 13.4% during the month to US$65.5/ton (after last month's rally that took everyone by surprise). Gold prices rose modestly (+0.6%) to $1,223 an ounce.

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

The S&P/ASX 200 Accumulation Index closed the month down 2.2%. This followed a poor month in October when the market was down 6.1%. Only two sectors, Financials (+1.4%) and Information Technology (+1.0%) were in positive territory, while all other sectors delivered negative returns, mostly notably, Energy (-10.3%).

The ASX 200 Resources Accumulation Index was the worst performer, down 6.5%, with Bluescope Steel (-21.9%) and South32 (-14.4%) contributing most to the underperformance. The ASX 200 Industrial Accumulation Index fell 1.1%, while the Small Ordinaries Accumulation Index was the best performer with a return of -0.4%, after taking the wooden spoon in October with a return of -9.6%.

The Materials sector (-4.8%) led down by BHP Billiton (-4.7%) and the Energy sector (-10.3%) led down by Santos (-16.9%) and Woodside Petroleum (-10.9%, pummelled by the continued fall in the oil price) were amongst the worst performers in terms of the contributions to the index. After being a significant underperformer last month, the Financials sector (+1.4%) was the standout contributor to the index. The sector's performance was led by Australia and New Zealand Banking Group (+6.5%), Commonwealth Bank of Australia (+2.9%) and National Australia Bank (+1.6%). Also, following a dreadful month in October, Information Technology rebounded strongly with Afterpay Touch Group (+15.5%) and Wisetech Global (+16.5%) leading the charge.

It's worth commenting on the Energy sector. On 14 November, there was a broad-based 7% sell-off in the crude oil price and the energy sector on the day. The sell-off was triggered by OPEC's report that supply was increasing and that next year's demand for its crude will be 500k barrels a day lower than its forecast only two months ago. The oil market suffered from a barrage of negative news flow including ineffective Iranian sanctions, stronger production from Saudi Arabia and Russia and higher inventories in the US. Reports coming out of strategists in Abu Dhabi also suggested that on November 6, Trump had apparently requested for the Saudi Crown Prince to keep WTI below US$70/bbl. Other points of discussion were the weak macro indicators of Chinese economic health, which have also been spurring anxiety in the oil complex.

The top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were BHP Billiton for the second month in a row (-32 points), CSL (-31 points), Woodside Petroleum (-22 points), Lendlease Group (-17 points, following a severe profit warning that saw the stock plunge 28.1%), and South32 (-17 points).

Four of the top five stocks that added to the index's return were financials: Australia and New Zealand Banking Group (+31 points), Commonwealth Bank of Australia (+22 points), National Australia Bank (+8 points), Insurance Australia Group (+7 points) and Qantas Airways (+5 points).

As was expected, the Reserve Bank of Australia kept the cash rate unchanged at 1.5% in November. It signalled that revisions to forecasts were likely to see the RBA achieving its goals of full employment and inflation back to the target mid-point sooner than anticipated. GDP growth in both 2018 and 2019 is now expected to be 3.5% for each years.

In trade weighted terms, the Australian dollar depreciated 2.3%, and 3.3% against the US dollar to end the month at 0.73.

CONTRIBUTION

Relative Value Gross Contribution -0.02%

Positive		Negative	
ELDERS - RURALCO HOLDINGS LTD	0.29%	CHARTER HALL RETAIL REIT - PEET	-0.23%
ARDENT LEISURE GROUP - VILLAGE ROADSHOW	0.18%	RIO TINTO - RIO TINTO	-0.21%
GROWTHPOINT PROPERTIES - INGENIA COMMUNITIES GROUP	0.17%	BHP BILLITON - BHP BILLITON	-0.19%
OOH!MEDIA - QMS MEDIA	0.10%	BWP TRUST - PEET	-0.11%
GPT GROUP - INGENIA COMMUNITIES GROUP	0.08%	CENTURIA CAPITAL - DEXUS PROPERTY GROUP	-0.09%

Special Situations Gross Contribution -1.76%

Positive		Negative	
HEALTHSCOPE LTD	0.05%	IMPEDIMED LTD	-0.53%
IVE GROUP LTD	0.05%	REDBUBBLE LTD	-0.25%
NUFARM LTD	0.02%	ONEVIEW HEALTHCARE PLC-CDI	-0.24%
SUNCORP GROUP NOTE	0.01%	INFIGEN ENERGY	-0.19%
CARINDALE PROPERTY TRUST	0.01%	AUSTRALIAN UNITY OFFICE FUND	-0.14%

Source: Ellerston Capital Limited

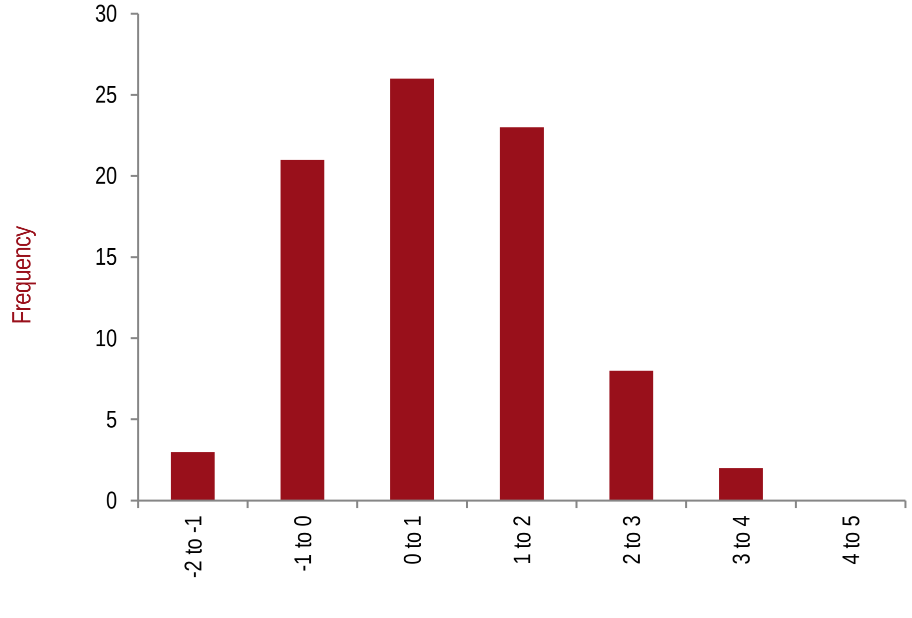
TOP 10 RELATIVE VALUE POSITIONS

- BHP BILLITON - BHP BILLITON
- RIO TINTO - RIO TINTO
- CENTURIA CAPITAL - DEXUS PROPERTY GROUP
- ELANOR RETAIL PROPERTY FUND - SHOPPING CENTRES AUSTRALASIA
- CENTURIA METROPOLITAN REIT - GROWTHPOINT PROPERTIES
- CENTURIA CAPITAL - GPT GROUP
- GROWTHPOINT PROPERTIES - INGENIA COMMUNITIES GROUP
- GPT GROUP - INGENIA COMMUNITIES GROUP
- BWP TRUST - CENTURIA CAPITAL
- CHARTER HALL RETAIL REIT - INGENIA COMMUNITIES GROUP

TOP 10 SPECIAL SITUATION POSITIONS

- S&P/ASX 200 INDEX PUT OPTIONS
- NUFARM FINANCE NZ LTD
- AUSTRALIAN UNITY OFFICE FUND
- INFIGEN ENERGY
- HEALTHSCOPE LTD
- IVE GROUP LTD
- SUPERLOOP LIMITED
- JOHNS LYNG GROUP LTD
- IMPEDIMED LTD
- ONEMARKET 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.

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