Ellerston Capital

Ellerston Australian Market Neutral Fund

Performance Report | October 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	-2.60	-4.34	-6.30	-5.45	1.16	5.97	6.97
RBA Cash Rate	0.13	0.38	0.76	1.50	1.60	1.90	1.95
Alpha	-2.73	-4.72	-7.06	-6.95	-0.44	4.07	5.02

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			-7.25
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	68%	Net Equity Exposure	+23.8%
No. Relative Value positions	93	Gross Portfolio Exposure	137.6%
No. Special Situations	35	Correlation Coefficient (vs ASX 200 Accum)	1.41%
Beta Adjusted	-3.8%	Net Sharpe Ratio (RFR = RBA Cash)	1.17

PERFORMANCE

The Fund returned -2.6% in October, underperforming the benchmark return of +0.1% in the period. Equity markets were weak across the board with the S&P/ASX200 falling 6.1%, and Small Caps (-9.6%) underperforming Large Caps (-5.7%). The contribution from Relative Value (-1.3% gross) and Special Situations (-1.2% gross) was relatively even, with both strategies struggling with the elevated volatility.

For the first month in six, our gross exposure increased in the period, closing the month at 137.6% (from 117.5% at the end of September). The increase reflects an environment which we believe is normalising, and one in which we think the Fund's historical return profile will resume. Net exposure at the end of October was +23.8% with a beta-adjusted net of -3.8%.

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	$532.5M
Liquidity	Daily
Application Price	$1.0316
Redemption Price	$1.0264
Management Fee	1.20%
Buy/Sell Spread	0.25%
Performance Fee	20% of outperformance
Firm AUM	Over $5 billion

The share price of Growthpoint Properties (-6.7%) retraced from its recent high, adding value to the Fund. Growthpoint has been somewhat of a market darling in 2018, with the stock rallying 17.6% during the first nine months of the year. Since the end of September however, the stock has underperformed the REIT sector which fell 3.1% in the month of October. Even with the recent pullback, Growthpoint continues to trade at a 13.8% premium to NTA, with FY19 earnings growth forecast to be zero.

Paired positions featuring a short in Shopping Centres Australasia (+7.1%) also added to performance in the month, with the REIT announcing the acquisition of ten convenience-based shopping centres, partly funded by a $259m equity placement. The assets were purchased from Vicinity Centres (+1.1%) on an initial yield of 7.5% on a fully-let basis, or 7.2% excluding the rental guarantee. The placement allowed us to buy-back our entire short position, closing down each of the pairs in which Shopping Centres featured.

The share price of land developer Peet Ltd (-6.0%) retreated during the month, underperforming the property sector and detracting from performance. Whilst we appreciate that the Australian residential cycle has turned, Peet remains incredibly cheap and trades at just 0.94x book value (where book value is calculated as the lower of cost or written-down value). Over the past few years, Peet has successfully diversified away from Western Australia, while at the same time avoiding Sydney and parts of Melbourne, which have been relatively expensive. In fact, over 90% of FY18 earnings was generated from eastern states' projects, up from less than 70% only 3 years ago.

During the month, Centuria Metropolitan REIT (-6.0%) announced the acquisition of four office assets from the Hines Global REIT for $520.9m. The acquisition was funded by a $276m equity raise, pitched at a 4.2% discount to the prevailing market price. Whilst the acquisition improves the quality of the office portfolio, the market struggled with the size of the raise and the stock closed the month well below the placement price. The acquisition also dragged down the share price of Centuria Capital (-4.0%), which raised capital to fund their share of the placement. Pairs featuring long position in both Centuria Metropolitan and Centuria Capital detracted from performance in the period.

The share price of QMS Media (-9.7%) underperformed its pair in oOh!media (-7.8%), with a number of newspaper articles suggesting QMS was on the cusp of another material acquisition. In separate articles during the month, QMS was rumoured to be buying in-cinema advertiser Val Morgan, NZ broadcaster Mediaworks, as well as McGuire Media and Crocmedia. The reality is that QMS is more likely to focus on the realignment of their existing assets, and trading at an EV/EBITDA multiple of 7.3x, just doesn't have the currency to embark on an acquisition binge. We remain content to hold our position, hedging the exposure with a short in oOh!media, which trades at an EV/EBITDA multiple of 9.2x.

The spread between the Australian and UK listings of BHP Billiton (-7.0%) and Rio Tinto (-3.0%) added value to the Fund, despite a fall in the GBPAUD cross-rate in the period.

The largest contribution to performance in the month came from our long position in the Australian Unity Office Fund (+7.5%), which was subject to a takeover proposal from Starwood Capital Asia. The proposal was pitched at a 9.7% premium to the previous closing price, a 10.5% premium to the last reported NTA and was Starwood's fourth attempt to acquire the REIT's assets. Given the premium offered, the Independent Board Committee has granted Starwood a period of up to 4 weeks to complete its due diligence and finalise its proposal. We expect a formal proposal will be tabled in November, with a scheme meeting scheduled for the new year.

Long positions in Infigen Energy (-16.9%), Superloop (-21.6%), OneMarket (-24.1%) and Impedimed (-12.1%) all detracted from the performance of the Fund in October. There was little news on any of the companies, but each suffered in line with the pullback in equities.

Our long position in index puts helped protect the value of the Fund during October.

ACTIVITY

Relative Value – Gross Contribution -1.26%

As previously mentioned, both Centuria Metropolitan and Centuria Capital raised money during October to fund the acquisition of an office portfolio from the Hines Global REIT. We participated in both placements, on a pro-rata basis, hedging the longs with short positions including Bunnings Warehouse (+3.6%), Goodman Group (+0.2%) and Growthpoint Properties.

We added to our paired position between Ruralco (-0.7%) and Elders (+2.8%), capitalising on a widening of the spread between the two stocks. We continue to prefer Ruralco to Elders, with Ruralco (5.9x EV/EBITDA) representing far better value than the less diversified Elders (11.4x EV/EBITDA).

The paired position between Carindale Property (-3.8%) and Shopping Centres Australasia was unwound in October, with the short exposure replaced with Scentre Group (+0.3%). Carindale is 60% owned by Scentre, who are also the manager of the Carindale shopping centre. With an NTA of $8.14 (based on a 5.0% cap rate) and a dividend yield of 5.2%, we are happy to maintain our holding in Carindale, with our expectation that the REIT will eventually be acquired by Scentre.

We increased our exposure to the BHP Billiton Ltd-Plc position during October, capitalising on an intra-month widening in the spread. Speculation around the timing and magnitude of capital management (announced post end-of-month), led to an increase in the volatility of the spread.

Special Situations – Gross Contribution -1.24%

We continued to add to our position in rural-services business PGG Wrightson (-4.9%), ahead of an expected capital return in early 2019. In August, PGG Wrightson announced that they had entered into an agreement to sell the PGW Seeds business for NZ$421m to DLF Seeds – a leading global seeds company. Following completion, the company is expected to make a non-taxable distribution to shareholders of approximately NZ$292m or NZ$0.387 per share. The strategic review is also continuing, with the market still expecting Elders will acquire the remaining rural service business.

Following the announcement of the takeover proposal from Starwood Capital Asia, we increased our holding in the Australian Unity Office Fund, adding to our position at a net annualised return of almost 11%. As previously mentioned, we expect the transaction to close early in CY2019.

The increase in market volatility led to a number of announced low-risk takeovers to trade lower intra-month. During the period we purchased and unwound modest stakes in Scottish Pacific (+0.2%) which is under takeover from Affinity Equity Partners, and Propertylink (+4.9%) which is under takeover from ESR Real Estate.

SECTOR ALLOCATION

Sector	Long Equity	Short Equity	Net Equity
Banks	0.4%	0.0%	0.4%
Div Financials	0.0%	0.0%	0.0%
Insurance	0.2%	0.0%	0.2%
Regional Banks	0.0%	0.0%	0.0%
REITs	53.2%	-40.0%	13.2%
Financials	53.9%	-40.0%	13.8%
Builders	1.0%	0.0%	1.0%
Consumer Disc	1.7%	-0.1%	1.6%
Consumer Staples	0.6%	0.0%	0.6%
Contractors	1.1%	0.0%	1.1%
Gaming	0.0%	0.0%	0.0%
General Industrials	2.4%	0.0%	2.4%
Health Care	3.5%	0.0%	3.5%
Information Technology	1.3%	0.0%	1.3%
Infrastructure	0.0%	0.0%	0.0%
Materials	0.7%	0.0%	0.7%
Media	1.8%	0.0%	1.8%
Telcos	0.0%	0.0%	0.0%
Utilities	3.6%	0.0%	3.6%
Industrials	17.6%	-0.1%	17.5%
Bulk Metals	6.6%	-6.5%	0.1%
Energy	0.4%	0.0%	0.4%
Gold	0.0%	0.0%	0.0%
Resources	7.0%	-6.5%	0.5%
Hedge	0.0%	-8.1%	-8.1%
Index	0.0%	-8.1%	-8.1%
Total	78.5%	-54.7%	23.8%

Source: Ellerston Capital Limited

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.

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.

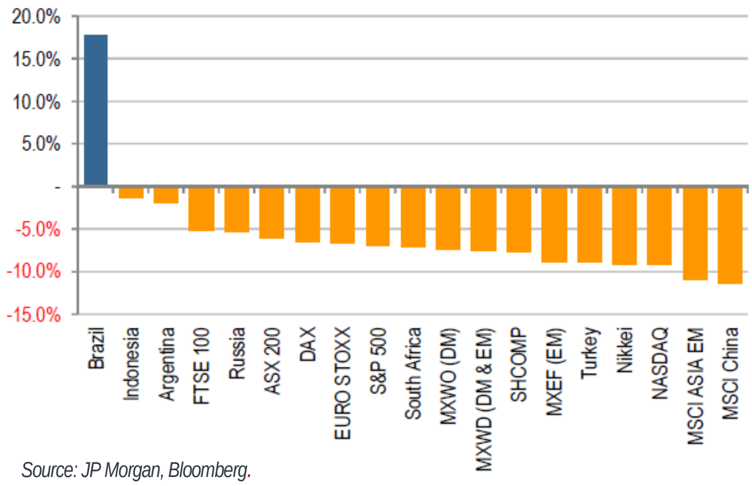
The European Central Bank kept rates unchanged in October as its view on the risks to growth were still described as "broadly balanced".

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.

CONTRIBUTION

Relative Value Gross Contribution -1.26%

Positive		Negative	
GROWTHPOINT PROPERTIES - INGENIA COMMUNITIES GROUP	0.11%	BWP TRUST - PEET	-0.24%
ELANOR RETAIL PROPERTY FUND - SHOPPING CENTRES AUSTRALASIA	0.05%	CENTURIA METROPOLITAN REIT - SHOPPING CENTRES AUSTRALASIA	-0.16%
RIO TINTO - RIO TINTO	0.03%	OOH!MEDIA - QMS MEDIA	-0.14%
CARINDALE PROPERTY TRUST - SHOPPING CENTRES AUSTRALASIA	0.02%	CHARTER HALL RETAIL REIT - PEET	-0.13%
BHP BILLITON - BHP BILLITON PLC	0.02%	CENTURIA METROPOLITAN REIT - GOODMAN GROUP	-0.12%

Special Situations Gross Contribution -1.24%

Positive		Negative	
AUSTRALIAN UNITY OFFICE FUND	0.40%	INFIGEN ENERGY	-0.70%
S&P/ASX 200 INDEX PUT OPTIONS	0.25%	SUPERLOOP LIMITED	-0.45%
HEALTHSCOPE LTD	0.07%	ONEMARKET LTD	-0.25%
NUFARM FINANCE NZ LTD	0.06%	IMPEDIMED LTD	-0.19%
PRO-PAC PACKAGING LTD	0.04%	ONEVIEW HEALTHCARE PLC	-0.16%

Source: Ellerston Capital Limited

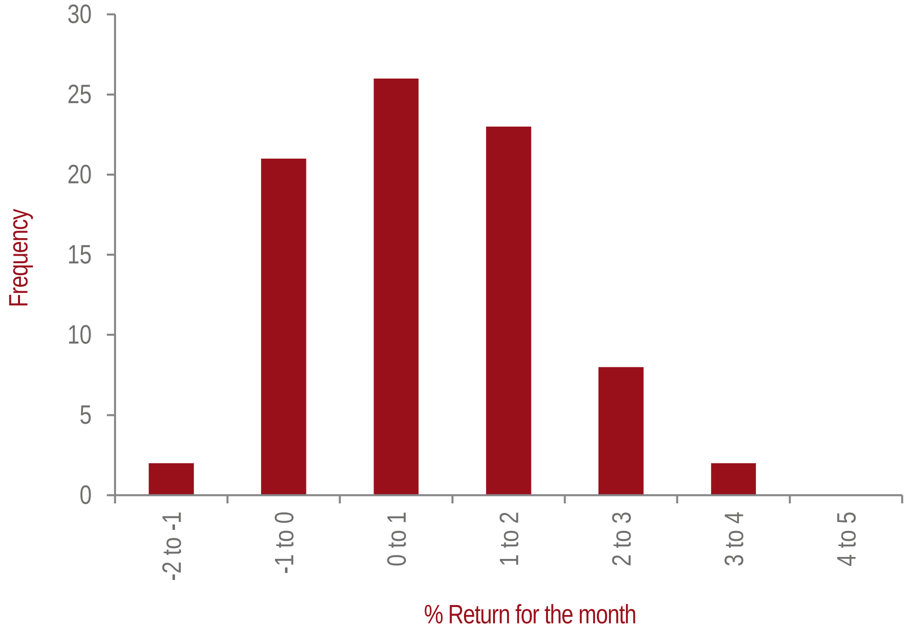
TOP 10 RELATIVE VALUE POSITIONS

- BHP BILLITON - BHP BILLITON PLC
- CENTURIA CAPITAL - DEXUS PROPERTY GROUP
- GROWTHPOINT PROPERTIES - INGENIA COMMUNITIES GROUP
- BWP TRUST - PEET
- RIO TINTO - RIO TINTO
- ELANOR RETAIL PROPERTY FUND - SHOPPING CENTRES AUSTRALASIA
- CHARTER HALL RETAIL REIT - PEET
- CHARTER HALL RETAIL REIT - INGENIA COMMUNITIES GROUP
- CENTURIA METROPOLITAN REIT - GROWTHPOINT PROPERTIES
- OOH!MEDIA - QMS MEDIA

TOP 10 SPECIAL SITUATION POSITIONS

- AUSTRALIAN UNITY OFFICE FUND
- S&P/ASX 200 INDEX PUT OPTIONS
- NUFARM FINANCE NZ LTD
- INFIGEN ENERGY
- CARINDALE PROPERTY TRUST
- SUPERLOOP LIMITED
- IVE GROUP LTD
- IMPEDIMED LTD
- PRO-PAC PACKAGING LTD
- HEALTHSCOPE 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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