Ellerston Capital

Ellerston Global Equity Managers Fund (GEMS)

Performance Report | January 19

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	0.68	-5.46	-15.80	4.66	10.77	10.09

Past performance is not a reliable indicator of future performance.

MARKET COMMENTARY

Market Overview

In January, equity markets rallied and provided some much needed relief after the painful end to 2018. Developed Markets (+7.3%) and Emerging Markets (+7.2%) both delivered strong, positive returns. Sentiment was boosted by the Federal Reserve suddenly turning dovish. The Fed downgraded the outlook for US economic growth from "strong" to "solid" and reduced future guidance saying that it "will be patient as it determines what future adjustments" to rates might be appropriate. The markets cheered the Fed's change of direction. Also, the White House improved its rhetoric towards China, leading to speculation of a more positive outcome from the US-China trade talks.

USA

The first signs that the trade war with China was impacting the US economy were evidenced in January. The December ISM manufacturing survey fell significantly to 54.1 (previous: 58.8) - the largest monthly decline since 2008 - dragged down by a fall in new orders. But equity markets looked forward and were buoyed by the prospect of a breakthrough in US-China trade talks, coupled with the Fed's pivot to being patient on rates. The S&P 500 Index and the Dow Jones Industrial Average Index delivered impressive returns in January after a torrid December, ending the month up 8.0% and 7.3% respectively. The NASDAQ performance was even stronger, up 9.8%.

In January, the Fed signalled that it would pause raising interest rates for a while and would be more flexible in reducing its bond holdings. The lower oil price, despite recent gains, meant that headline inflation for December came in at 1.9% year-on-year, easing the pressure on the Fed to raise rates (and from suffering the barbs from President Trump's tweets), providing much relief to equity markets.

Having entered January with the government partially shut down, the US ended its record 35-day partial government shutdown late in the month. The Congressional Budget Office expects that all of the real GDP lost as a result of the shutdown should be recovered by the end of the year. However sentiment was negatively impacted: the University of Michigan's Consumer Sentiment Index for January fell sharply to 90.7 from 98.3.

Approximately 40% of stocks in the S&P 500 Index have reported earnings so far and the EPS beat rate is above its historical average. Looking forward, the US markets will likely be sensitive to where earnings forecasts settle following reporting season and progress on US-China trade talks.

Europe

European equity markets were also much stronger in January, catching some of the improving global sentiment. The Euro STOXX 50 Index rose 5.5%, as economic data continued to soften, with Europe caught in the crossfire of the trade war that has led to a fall in demand from China. Manufacturing PMI fell to 50.5 (previous: 51.4) and the new export orders component of the PMI for the Eurozone remained below 50. Composite PMI also fell to 50.7 (previous: 51.4). In France, the flash PMI fell further as the "yellow vest" protests continue to impact the economy. In Italy, budget proposals were approved by the government and the Italian president, easing near-term risks, resulting in a drop in the Italian 10-year bond yield. Brexit continues to dominate the UK headlines. The UK Prime Minister lost a major vote in parliament and failed to win support for

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$161.0M
Liquidity	Quarterly
Application Price	A$ 1.4369
Redemption Price	A$ 1.4297
No. Stocks	84
Gross Exposure	109%
Net Exposure	65%
Management Fee	1.50% p.a.
Buy/Sell Spread	0.25%
Performance Fee	16.50%
Firm AUM	Over A$5b

the deal negotiated with Europe over two years. The UK remains locked in a divisive battle with itself on the best way forward to realise Brexit, with the probability on a “no-deal” Brexit changing weekly. The ECB left its policy rates unchanged, but made reference to a persistence of negative factors impacting euro area growth and moved the outlook to the downside.

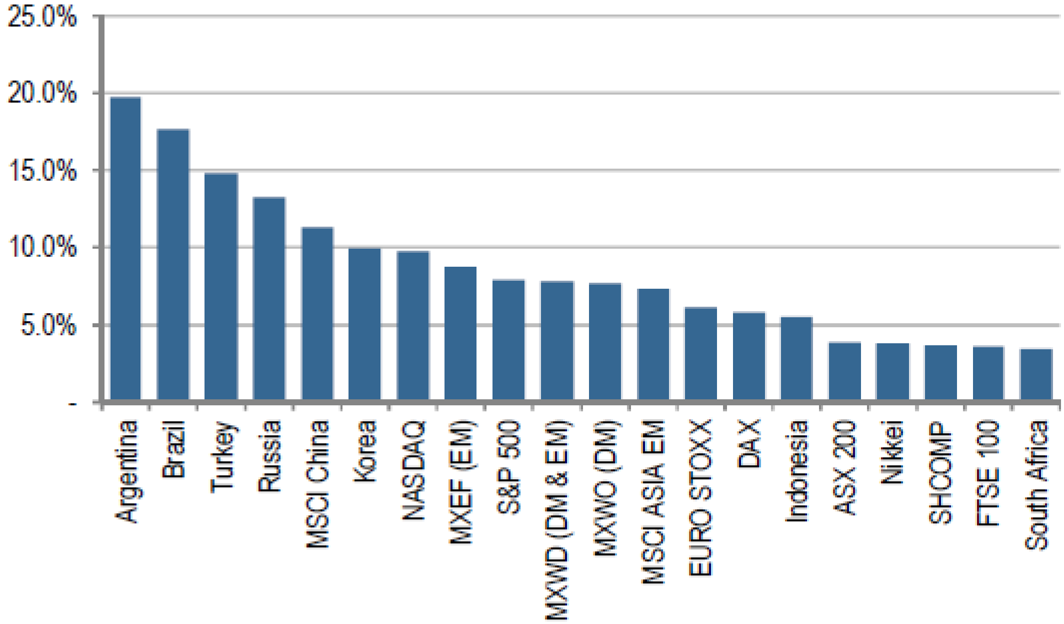
The market however looked through the data with all major European indices in the black. The UK’s FTSE 100 was up 3.6%, France’s CAC 40 was up 5.6% and Germany’s DAX rose 5.8%.

Asia

Asian equities also benefitted from the optimism on US-China trade talks and the Fed’s pivot away from tighter monetary policy. The Hang Seng Index was up 8.1%, Korea’s KOPSI Composite Index was up 8.0%, the Chinese market represented by the SSE Total Market Index was up 5.1%, while Japan’s Nikkei 225 was up 3.8%.

But the issue hovering over global markets including Asia, is the slowdown in China. Chinese real GDP in December slowed to a post-GFC low of 6.4% year-on-year. The Chinese consumer is weakening and domestic demand is slowing on top of the pressure from the ongoing trade war with the US. The Chinese authorities have looked to provide some stimulus, including lowering the banks’ Reserve Requirement Ratio by 100 basis points. Further easing is expected going forward. This has been supportive of emerging markets generally.

Global Equity Markets’ Performance in January 2019



Source: JP Morgan, Bloomberg

Commodities

The LME Metals Index was up 5.2% in the month. Nickel was the star performer (+17.0%) followed by Zinc (+8.4%), Tin (+7.2%) and Lead (+4.6%).

Bulk commodity prices were mixed in January. A dam collapsed in Brazil with tragic consequences and major implications for the supply of Iron Ore. Vale, the world’s largest producer of Iron Ore and the owner of the dam, announced large output cuts and this pushed up the Iron Ore price by US$13/ton to US$84.5/ton. Thermal coal was broadly flat and hard coking coal fell.

OPEC cuts and the US government’s sanctions on Venezuela pushed up Brent Oil prices, which rose by US$8.09/barrel to US$61.89/barrel. Gold prices were up again in January despite the rally in equities.

Bonds

The bond rally continued into early January but then sold off, only to rally again after the Fed made its more dovish pronouncements. The US curve flattened as the spreads between long-term rates and short-term rates narrowed. US 10-year bond yields fell 5.5 basis points, closing the month at 2.63%. US 2-year bond yields fell 3 basis points to 2.46%.

The Australian 10-year bond yield fell 7.5 basis points to 2.24%.

Australia

Australian shares participated in the global rally with the S&P/ASX 200 Accumulation Index closing the month up 3.9%. With the exception of the Financials sector, all sectors delivered positive returns. The best three performing sectors were Energy (+11.5%), Information Technology (+9.3%) and Communication Services (+7.8%). The worst three performing sectors were Financials (-0.2%), Consumer Staples (+2.8%) and Industrials (+3.1%).

In January, the ASX 200 Resources Accumulation Index was once again the best performer, up 9.2%. BHP Group (+6.2%), was the most significant contributor with the strength in iron ore driving the stock higher. Rio Tinto (+10.9%) and then Woodside Petroleum (+9.6%) followed, with the rally in the oil price helping. The ASX 200 Industrial Accumulation Index brought up the rear with a +2.6% return, while the Small Ordinaries Accumulation Index returned a very credible 5.6%.

The Financials sector (-0.2%) was, for the second month running, the single biggest detractor from the index. The overall market was negatively impacted by falls in Commonwealth Bank of Australia (-3.4%) and Westpac Banking Corporation (-2.0%), with the other two major banks also underperforming the index given fears that the final report of the Royal Commission into financial services might contain further negative surprises. Also, a profit warning from Challenger (-23.7%) saw investors sell the stock down aggressively (see separate write up).

The top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were Commonwealth Bank of Australia (-28 points), Westpac Banking Corporation (-10 points), Resmed (-9 points), Challenger (-8 points) and Costa Group (-4 points).

The top five stocks that added to the index's return were BHP Group (+38 points), CSL (+30 points), Rio Tinto (+20 points), Telstra (+20 points) and Woodside Petroleum (+19 points).

Domestically, there was continued pressure on house prices. National Corelogic dwelling prices fell 1.0% month-on-month in January, putting the year-on-year decline at -5.6% (the worst since March 2009). But employment data continued to appear robust, with the unemployment rate ticking down to 5.0% (previous: 5.1%). A decline in participation explained part of the fall but 21k new jobs in December also contributed to the lower rate. More concerning was the sharp collapse in NAB business conditions to +2 in December (previous: +11), the biggest drop since October 2008. NAB's business confidence remained flat at +3, but Westpac Melbourne Institute's consumer sentiment dropped by 4.7% month-on-month.

The Australian dollar rose 2.5 cents against the US dollar to close the month at $0.729, with the Fed's pivot away from tighter monetary policy negatively impacting the US dollar. In trade-weighted terms, the AUD appreciated 1.5%.

Outlook and Portfolio Commentary

We remain cautiously optimistic for finding good investment opportunities following the tumultuous markets of late 2018 and early 2019. One thing is for certain – we expect the volatile investment environment to continue well into in 2019.

Globally, we recently highlighted the concerns investors had over the potential for a monetary policy mis-step by the Fed. So unsurprisingly, the Fed turning dovish with its rate guidance in January had markets cheering. This has eased market fears in the short-term that the Fed was tightening rates too aggressively as the pace of global growth was slowing. It's unclear if the Fed will maintain its neutral stance if inflation and wage data in the US are stronger than anticipated, as the US payroll data trends remain very solid. Additionally, the harsh rhetoric from the US administration with respect to US-China trade talks has softened somewhat. A positive outcome from the talks would be welcome relief to the markets, as the trade war has hurt China, Europe and now seems to be biting in the US. That said, investors remain nervous with macroeconomic data pointing to weakening global growth and political uncertainty around the world continuing to act as likely headwinds. We'd like to reiterate the risks to investment markets we've previously identified. These include the negative effects of a trade war, slowing global growth (especially in China, where there are increasing concerns that the slowdown in their economy might be worse than initially feared) and the uncertainty and incoherence emanating from Trump's White House – a risk factor that the market is only now seemingly fully coming to grips with.

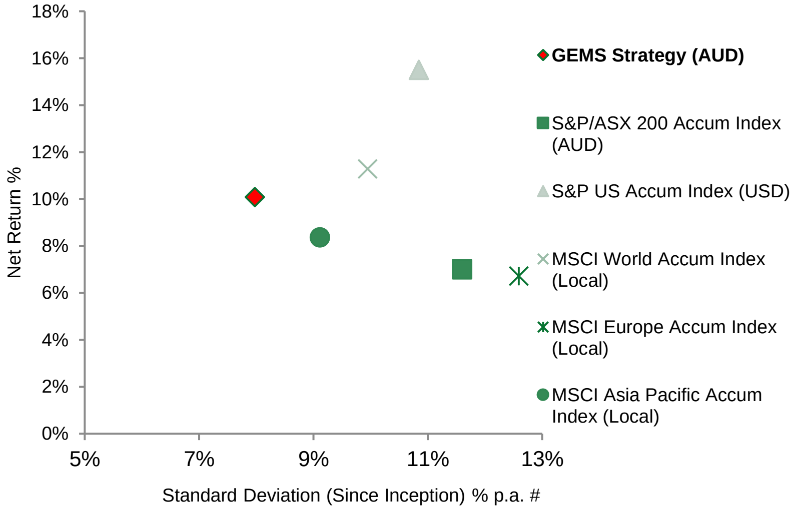
Domestically, the risks include the second-order effects of the macro drivers above, along with sharply slowing credit growth, an indebted consumer, fear of a harder economic landing and a pending Federal election this year. It makes for a very volatile investment environment in 2019. The recent correction in many stock prices has left us with plenty of fresh opportunities to investigate. 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. Following the rally in January, the ASX 200 Index is now trading at a PE multiple of 14.7 times, compared to its peak reached in August 2018 of 15.9 times. The Industrials ex-Financials have de-rated from a peak multiple of 22.2 times to now around 20 times. The current reporting season will be critical for earnings forecasts to support the market.

During January, we have kept the portfolio's gross long exposure steady at 87% but slightly decreased exposure to Australia & New Zealand, offset by a small increase in exposure to North America. We have decreased its gross short exposure from 32% to 22% through roughly equal decreases to exposure in both those same geographies. In terms of sectors, we conducted small rebalancing across a range of sectors. The most significant moves were increasing the portfolio's long exposure and decreasing short exposure in Information Technology, and trimming long exposure to Financials. We also reduced our hedging at the portfolio level. The aggregate result continues the trend of recent months towards reduction in total gross exposure of the portfolio (this month, from 119% to 110%) but increased the portfolio's total net exposure (from 55% to 65%).

ELLERSTON CAPITAL

Market Exposure as a % of NAV

GEMS Strategy Performance & Volatility ^



Top Holdings (Alphabetical, Long only)

- ALPHABET
- BP
- CLOVER CORP
- EZCORP
- GENERATION DEVELOPMENT
- GRAINCORP
- HEALTHSCOPE
- NEWCREST MINING
- NUFARM
- PSC INSURANCE

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

Source: Ellerston Capital

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.