ELLERSTON CAPITAL

Ellerston Australian Market Neutral Fund

Performance Report | January 19

FUND PERFORMANCE (%)

	1 Month	3 Months	6 Months	1 Year	3 Years p.a.	5 Years p.a.	Since Inception p.a.
Fund Net	-0.92	-5.25	-9.37	-12.10	-1.13	3.87	5.65
RBA Cash Rate	0.13	0.38	0.75	1.50	1.56	1.85	1.93
Alpha	-1.05	-5.63	-10.12	-13.60	-2.69	2.02	3.72

Source: Ellerston Capital Limited

	Jan	Feb	Mar	April	May	June	July	Aug	Sep	Oct	Nov	Dec	YTD
2019	-0.92												-0.92
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	65%	Net Equity Exposure	+24.8%
No. Relative Value positions	87	Gross Portfolio Exposure	170.6%
No. Special Situations	28	Correlation Coefficient (vs ASX 200 Accum)	2.98%
Beta Adjusted	3.4%	Net Sharpe Ratio (RFR = RBA Cash)	0.82

PERFORMANCE

The Fund returned -0.9% in January, underperforming the benchmark return of +0.1% in the period. Both Relative Value and Special Situations detracted from performance, with each contributing -0.4% (gross) to performance.

Net exposure was +24.8% with a beta-adjusted net of +3.4%. Gross exposure closed the month at 170.6%.

We continue to see a significant amount of “embedded value” within the portfolio, with the expected return-to-target-price of our holdings close to since-inception highs. We remain confident that we will be able to crystallise the embedded value in a market environment that is showing signs of normalising.

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	$430.1M
Liquidity	Daily
Application Price	$0.9617
Redemption Price	$0.9569
Management Fee	1.20%
Buy/Sell Spread	0.25%
Performance Fee	20% of outperformance
Firm AUM	Over $5 billion

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Once again, our paired position between Village Roadshow (+12.5%) and Ardent Leisure (-8.4%) was the largest positive contributor within Relative Value. Weather conditions in South East Queensland have continued to favour theme park attendance while the Australian box office looks to be outperforming (modest) expectations. A media campaign to change management and potentially break up the business, served to increase interest in the intrinsic value within the company. Despite the move, Village trades on an FY19 EV/EBITDA multiple of just 6.7x, with the potential for earnings to be upgraded at the H1 result in February.

Our paired position within the rural-services sector also added value, with Ruralco (-0.7%) outperforming Elders (-11.3%) in the period. Interest in a Ruralco-Elders tie up seems to be increasing, with a number of sell-side analysts "dusting off the file" on how a merged entity would look. Given the difference in EV/EBTIDA multiples between the two (Elders at 10.2x vs Ruralco at 6.3x), even a deal struck at a significant premium would be accretive. We have long believed in the merit of a merger between the two companies and will continue to closely monitor the sector.

A disappointing share price performance from QMS Media (-8.2%) detracted from the performance of the Fund in January. The market is becoming increasingly impatient with the lack of disclosure from QMS around the strategic merger of their NZ business with Mediaworks NZ. Despite the transaction being announced in November, investors are yet to get clarity around the earnings contribution from the newly-formed NZ division. Investors are also unsure as to how to value the QMS Sport business, which includes the in-stadium advertising rights to various global sporting events. The result of all this uncertainty is a company that trades at Price/Earnings ratio of just 8.9x, compared with oOh!media (+4.7%) which trades at 11.3x.

We continue to be frustrated by the share price performance of Centuria Capital (+5.9%), a diversified fund manager with a focus on real estate. Our frustration is further heightened by the share price performance of its closest peer, Charter Hall (+10.9%), which continues to reach new highs. The recent rally in Charter Hall means the stock trades at an eye-watering Price/Earnings ratio of 20.0x, compared with Centuria at just 12.6x. Our holding in Centuria, as part of a number of pairs, detracted from the performance of the Fund.

The contribution from Special Situations in January was hampered by our holding in index put options, which fell in value as the market rallied. We typically hold a long in index put options to hedge the net exposure of the Fund and protect against a falling market. The strong bounce in the equity market, coupled with a fall in volatility, meant our put option position detracted from the value of the Fund.

Our position between merger candidates Eclipx Group (-8.2%) and McMillan Shakespeare (+10.4%) also detracted from performance, with the spread between the two widening following an earnings downgrade from Eclipx. Whilst the magnitude of the downgrade was modest and well below the threshold that would trigger the merger's Material Adverse Effect clause, a number of investors unwound their positions, sending Eclipx lower and McMillan higher.

A long position in Healthscope (+5.8%) added to the value of the Fund, with increasing certainty around the legitimacy and timing of the Brookfield takeover helping to push the share price higher (the transaction was confirmed in early February). Whilst there still remains a small chance of a competing bid from the BGH-led consortium, we expect that Brookfield bid will be successful, with a final price of between $2.40 and $2.50 per Healthscope share.

The share price of Impedimed (+18.4%) was stronger in January, adding to the performance of the Fund. During the period, the company announced that the interim results of the PREVENT trial will be presented at the 2019 Annual Meeting of the American Society of Breast Surgeons in April. The company also announced that it had received a multi-year national purchasing agreement for SOZO from Ascension Health Resources – the largest non-profit health system in the US. Finally, Impedimed reported its strongest quarter of SOZO sales yet, with annual recurring revenue up by 39% in the period.

ACTIVITY

Relative Value – Gross Contribution -0.44%

During the month, we introduced a paired position between fuel refiners/retailers Viva Energy (+2.2%) and Caltex Australia (+5.3%). The recently-listed Viva Energy imports, refines, and retails fuels and lubricants across the Australian market, with the petrol and convenience business predominantly run under the Shell banner. Viva is a well-run business that is currently under-earning from its 1,150 petrol station platform and suffers from cyclically low refining margins. At the current share price, the company trades on a Price/Earnings ratio of 11.9x and an EV/EBITDA multiple of less than 6.3x, both on depressed earnings. We expect Viva will re-rate over time to trade closer to the multiples of its nearest peer, Caltex.

Ahead of the Federal Government issuing a number of new MRI licences, we established a paired position within the healthcare sector, purchasing Capitol Health (+1.9%) and hedging the exposure with Integral Diagnostics (-3.2%). Both Capitol and Integral Diagnostics are providers of diagnostic imaging (including MRI, Ultrasound, CT, X-Ray) and would benefit from an additional MRI licence. Capitol, however, is the smaller of the two and trades at a 17% discount to Integral, despite having superior growth forecasts. Capitol also has an active buyback, which will resume purchasing shares following the release of their results in late February.

Due to a narrowing of spreads, we reduced our exposure to the Village – Ardent and the Ruralco – Elders pairs. We also unwound our paired position between Aventus (-0.5%) and Charter Hall.

Special Situations – Gross Contribution -0.37%

We added to our long position in Eclipx Group, hedging the exposure with a short in McMillan Shakespeare at the announced merger ratio. Despite the modest earnings downgrade from Eclipx in the period (discussed above), we expect the deal to close at the announced terms, albeit with a delay to the original merger timetable.

We reduced our holding in IVE Group (+4.8%), Pro-Pac Packaging (-2.5%), Paragon Care (-7.8%), and completely exited our position in Redbubble (+7.8%).

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	51.3%	-42.6%	8.7%
Financials	**51.3%**	**-42.6%**	**8.7%**
Builders	1.7%	0.0%	1.7%
Consumer Disc	3.5%	0.0%	3.4%
Consumer Staples	3.3%	-0.4%	2.9%
Contractors	0.0%	0.0%	0.0%
Gaming	0.0%	0.0%	0.0%
General Industrials	4.2%	-2.2%	2.0%
Health Care	4.0%	-0.1%	3.9%
Information Technology	1.4%	0.0%	1.4%
Infrastructure	0.0%	0.0%	0.0%
Materials	0.0%	0.0%	0.0%
Media	3.0%	0.0%	3.0%
Telcos	0.0%	0.0%	0.0%
Utilities	3.0%	-1.5%	1.5%
Industrials	**23.9%**	**-4.2%**	**19.8%**
Bulk Metals	19.0%	-18.9%	0.1%
Energy	0.6%	-0.3%	0.3%
Gold	0.0%	0.0%	0.0%
Resources	**19.6%**	**-19.3%**	**0.4%**
Hedge	0.0%	-4.0%	-4.0%
Index	**0.0%**	**-4.0%**	**-4.0%**
Total	94.9%	-70.1%	24.8%

Source: Ellerston Capital Limited

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 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.

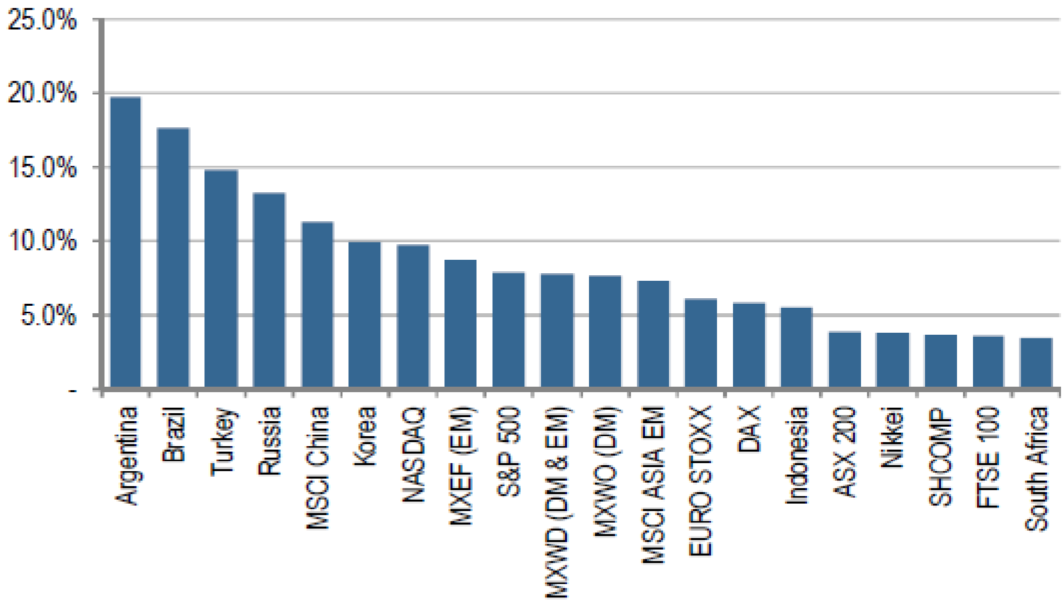
The market however looked through the data with all major European indices in the black. The UK's FTSE 100 was up 3.6%, France's CAC 40 was up 5.6% and Germany's DAX rose 5.8%.

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.

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%.

CONTRIBUTION

Relative Value Gross Contribution -0.44%

Positive		Negative	
ARDENT LEISURE GROUP - VILLAGE ROADSHOW	0.25%	OOH!MEDIA - QMS MEDIA	-0.26%
CHARTER HALL RETAIL REIT - PEET	0.15%	CARINDALE PROPERTY TRUST - GOODMAN GROUP	-0.17%
BWP TRUST - PEET	0.12%	CENTURIA METROPOLITAN REIT - GOODMAN GROUP	-0.15%
ELDERS - RURALCO HOLDINGS LTD	0.10%	CHARTER HALL GROUP - INGENIA COMMUNITIES GROUP	-0.14%
CENTURIA CAPITAL - SHOPPING CENTRES AUSTRALASIA	0.10%	GPT GROUP - INGENIA COMMUNITIES GROUP	-0.11%

Special Situations Gross Contribution -0.37%

Positive		Negative	
IMPEDIMED LTD	0.15%	S&P/ASX 200 INDEX PUT OPTIONS	-0.30%
HEALTHSCOPE LTD	0.13%	ECLIPX GROUP LTD	-0.20%
ONEMARKET LTD	0.08%	MCMILLAN SHAKESPEARE LTD	-0.15%
IVE GROUP LTD	0.08%	SUPERLOOP LIMITED	-0.10%
CATAPULT GROUP INTERNATIONAL	0.05%	ELK PETROLEUM LTD	-0.07%

Source: Ellerston Capital Limited

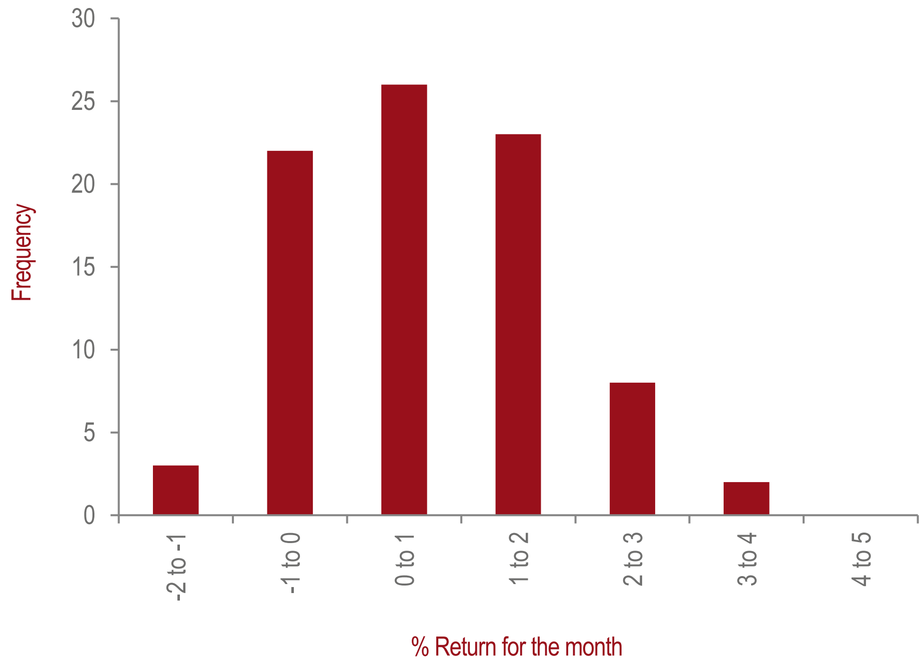
TOP 10 RELATIVE VALUE POSITIONS

- RIO TINTO - RIO TINTO
- BHP BILLITON - BHP BILLITON
- CENTURIA CAPITAL - DEXUS PROPERTY GROUP
- BWP TRUST - CARINDALE PROPERTY TRUST
- CHARTER HALL GROUP - PEET
- CENTURIA CAPITAL - GPT GROUP
- AUSTRALIAN UNITY INVESTMENT REAL ESTATE - NATIONAL STORAGE REIT
- CHARTER HALL GROUP - INGENIA COMMUNITIES GROUP
- AGL ENERGY LTD - INFIGEN ENERGY
- GPT GROUP - INGENIA COMMUNITIES GROUP

TOP 10 SPECIAL SITUATION POSITIONS

- NUFARM FINANCE NZ LTD
- S&P/ASX 200 INDEX PUT OPTIONS
- ECLIPX GROUP LTD
- MCMILLAN SHAKESPEARE LTD
- HEALTHSCOPE LTD
- SUPERLOOP LIMITED
- IVE GROUP LTD
- JOHNS LYNG GROUP LTD
- IMPEDIMED LTD
- SUNCORP GROUP NOTE

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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