Ellerston Capital

Ellerston Overlay Australian Share Fund (OASF)

Performance Report | December 18

PERFORMANCE SUMMARY

Gross %	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.	Strategy Since Inception p.a.
OASF	0.09	-11.03	-9.21	7.00	5.71	9.76
Benchmark	-0.12	-8.24	-2.84	6.69	5.63	9.44

Past performance is not a reliable indicator of future performance.

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%!

Investment Objective

The Investment objective for the Ellerston Overlay ASF is to outperform the S&P/ASX 200 Accumulation Index (Benchmark).

Investment Strategy

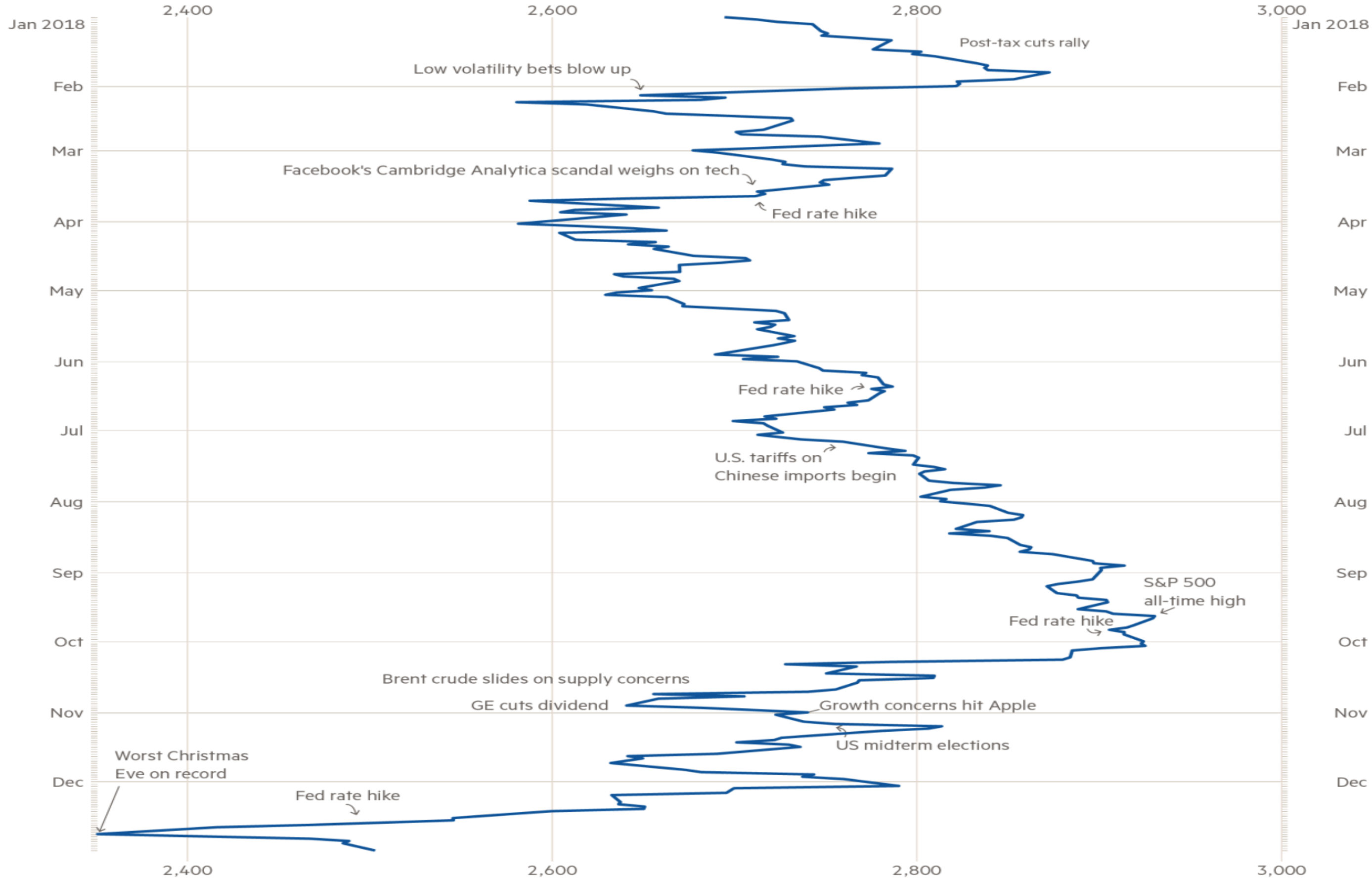
The Fund uses a benchmark-independent, high conviction approach that looks beyond investing in the Top 20 Australian equity stocks in order to capture the neglected opportunities and uses derivatives to enhance income

Key Information

Strategy Inception Date	4 January 2012
Fund Net Asset Value	$1.0184
Liquidity	Weekly
Application Price	$1.0209
Redemption Price	$1.0159
No Stocks	18
Management Fee	0.90%
Buy/Sell Spread	0.25%
Performance Fee	15%
Firm AUM	Over $5 Billion

For US equities, 2018 was the worst year since the financial crisis

S&P 500 index



Source: Bloomberg, FT research
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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.

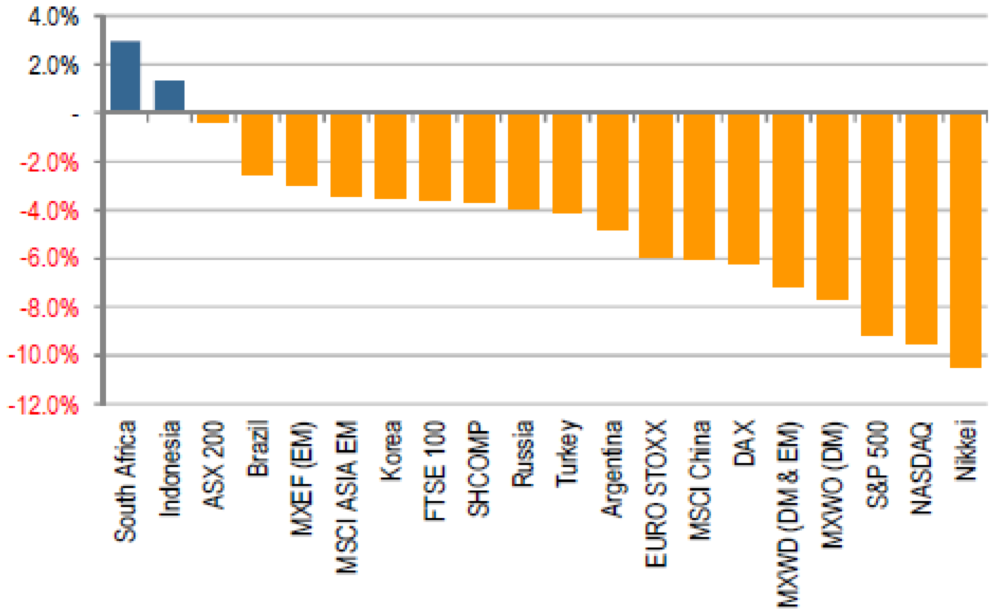
All major European indices were in the red. The UK's FTSE 100 was down 3.5%, France's CAC 40 was down 5.2% and Germany's DAX fell 6.2%. The DAX is the worst performing major European market in 2018, with a return of -18.3%.

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).

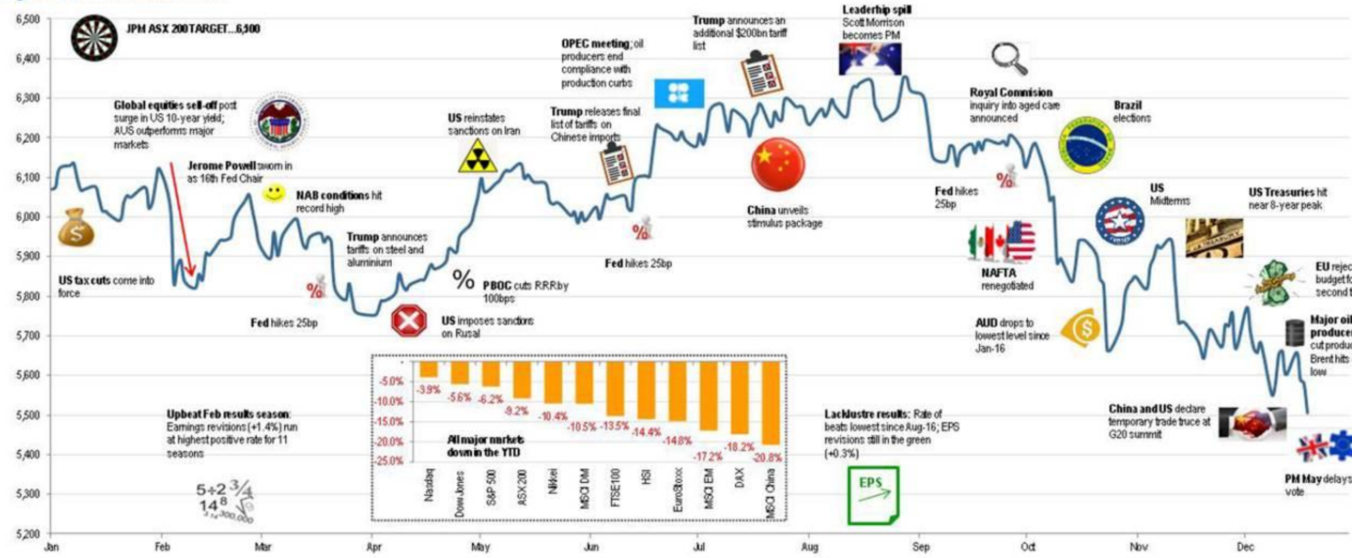
The top five stocks that added to the index's return were BHP Group (+76 points), CSL (+24 points), Commonwealth Bank of Australia (+14 points), Rio Tinto (+13 points) and Transurban Group (+9 points).

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.

COMPANY SPECIFIC NEWS

The Market Misses

Pilbara Minerals/Orocobre (PLS -25.6%/ ORE -25.2%)
It was tough month for lithium players PLS and ORE, as the lithium price came under renewed pressure. A slower than expected take-up in battery demand, coupled with increased supply of lithium out of Chile and Australia dampened enthusiasm for the sector.

IOOF Holdings (IFL -25.1%)
IFL had a terrible month as APRA looked to make an example of the company following the combative performance by CEO Chris Kelaher at the Royal Commission. APRA imposed additional licence restrictions against IFL's regulated entities and sought disqualification orders against 5 senior executives, including the Chairman George Vernados and CEO Chris Kelaher. With questions hanging over the company transforming ANZ acquisition, concerns about brand damage and with management in a state of flux, it could be some time before investor confidence is restored.

Lynas Corporation (LYC -24.5%)
The review of LYC's rare earth processing plant in Malaysia gave a positive finding, highlighting that the operations were low risk and compliant. However that was of little comfort to investors, as the Ministry imposed tough new conditions, including the export of radioactive residues. Finding a home for the residue will not be simple and is likely to be costly. LYC has until September 2019 to come up with a plan.

Nine Entertainment (NEC -21.4%)
NEC completed its merger with Fairfax during December and whilst the company upgraded the synergy target by $30 million, weakness across the advertising space sent the sector into sharp decline. SMI ad booking data for November fell 10% across the board, with newspapers falling a massive 24% for the month. Television also printed one of its worst months, down 6.6%.

Mayne Pharma (MYX -21.0%)
After a strong run early in the year, MYX has now given up nearly all its gains, falling from a peak of $1.30 to close the year at $0.78. The generic drug market in the US has been under maximum pressure as the Department of Justice probe into price-fixing, casts a dark could over the entire sector.

Ooh! Media (OML -20.7%)
OML was also squeezed by the sharp decline in advertising spend and subsequent sentiment impact. Whilst outdoor remains the pick of the advertising medium, the slowdown in growth from CY18 of +11% to just +3% in November, surprised.

The Market Hits

Graincorp (GNC +25.6%)
GNC topped the list of winners in December after Long Term Asset Partners (LTAP) announced a $2.4 billion takeover for the company. Mystery surrounded the financial credentials of LTAP which saw the stock trade at a significant discount to the $10.42 cash bid, despite the major step of GNC granting the suitor access to conduct due diligence.

Resolute/Saracen/Evolution/Northern Star/Regis (RSG +21.6/SAR +18.6%/EVN +17.5%/NST +15.8%/RRL +13.9%)
The stars finally aligned for gold investors in December as money looked for a safe-haven amid market uncertainty. Outside of takeover targets GNC and SIG, the gold sector provided the 5 best returning stocks for the month as the commodity rallied towards US$1,300 an ounce.

Sigma Health (SIG +16.3%)
SIG was another company to benefit from a takeover approach during December as rival pharmaceutical distributor Australian Pharma (API) lobbed in an opportunistic bid for the group. API backed-up its intentions by taking a 13% stake in Sigma at A$0.64. ACCC will be the main hurdle going forward.

BHP Limited (BHP +11.5%)
The power of buybacks was on display as Australia's mining behemoth bought back more than US$5bn of its own securities in December. In addition, it declared a special dividend to be paid in January of US$1.02 per share. That said, bulk commodities remained resilient with both metallurgical coal and iron ore holding up despite concerns of a global economic slowdown. Fellow major miners South 32 and Rio Tinto also had strong months.

AGL Energy (AGL +9.5%)
After what can only be described as a tough year for AGL in 2018, it finished the year on a brighter note for shareholders, rallying the best part of 10%. Confirmation that acting CEO Brett Redman would be given the role permanently, provided elements of certainty for the energy retailer, in a sector that still has plenty of political questions to answer.

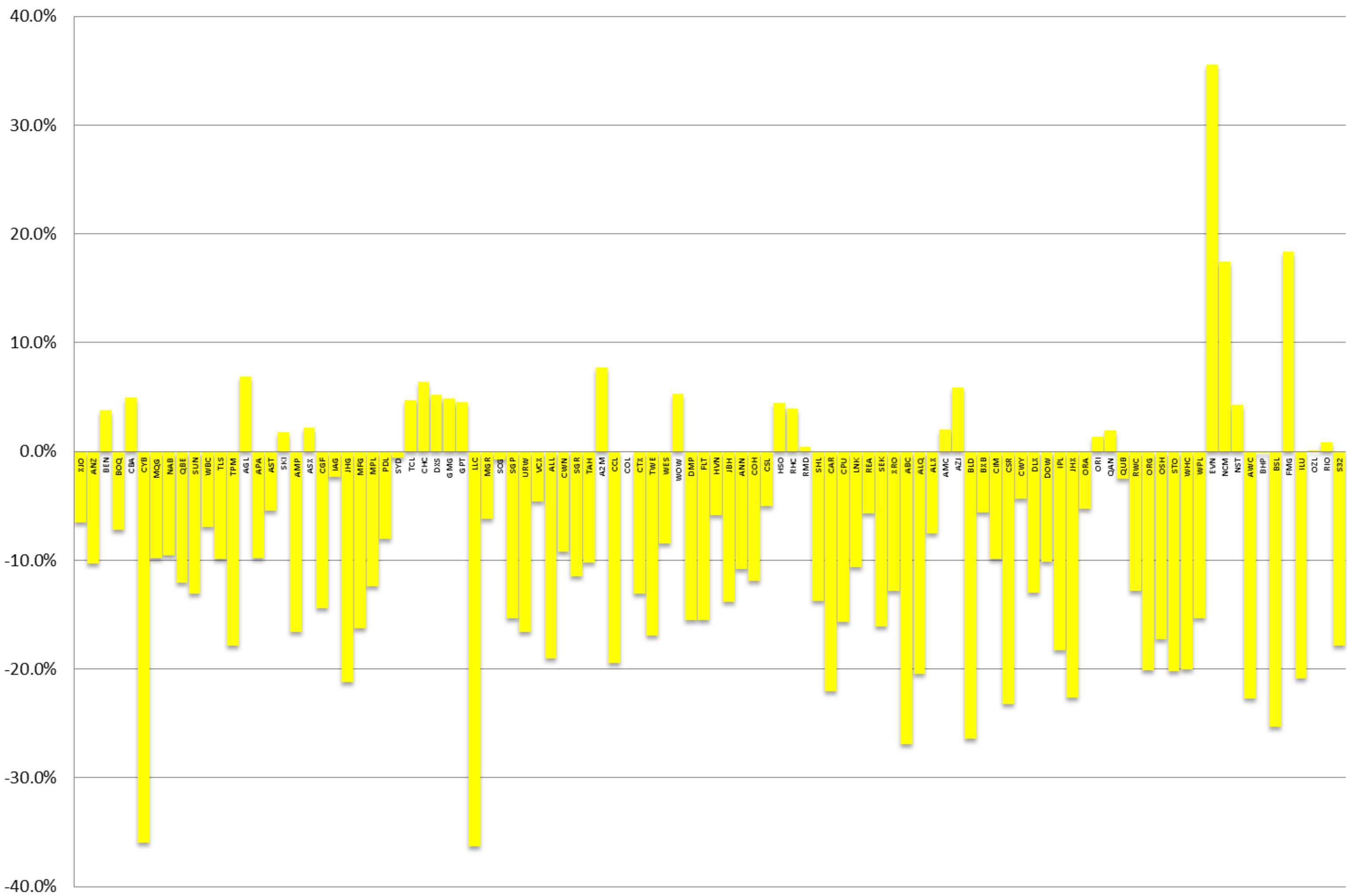
FUND PERFORMANCE

In a further global market sell off and period of continued volatility, your Fund delivered a positive return of 0.09%, slightly outperforming the benchmark return of -0.12% over the period.

That said, it caps off an underwhelming set of performance numbers for 2018, with most of the damage done in the back half of the calendar year. We are extremely disappointed that despite correctly identifying reasons to be cautious and being seemingly defensively positioned, the fund has underperformed. Many of the fund's larger Core holdings (to our surprise), have suffered significant de-ratings (Treasury Wines, Woodside, Bluescope), even as they continue to reiterate earnings outlooks or guidance. We struggle with this phenomenon and would expect rational behaviour to return based on solid fundamentals. Treasury Wines now trades on 22 times consensus current year earnings with 25% earnings growth versus non-bank industrials on 19 times with pedestrian earnings growth. Tabcorp, your typical defensive name, finished the year down 19.4%, an outcome we did not envisage.

It is interesting to note that 57 of the top 100 companies have corrected over 20% from their recent highs achieved over the year. If you look at the performance of the top 100 stocks over the December Quarter, this is throwing up a number of buying opportunities for the Fund in stocks we have been monitoring for years and have wanted to own for some time.

S&P/ASX 100 - 3 Month Price Change to 31 December 2018

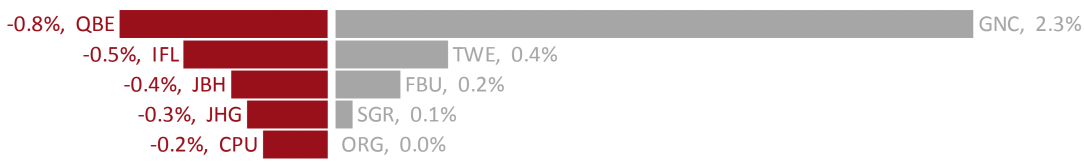


Source: Shaw and Partners Research.

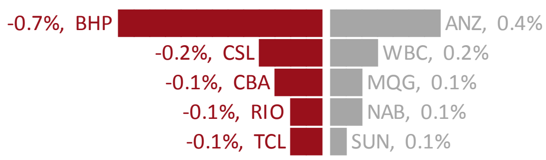
Returns[1] (%)	Gross	Benchmark	Excess	Net
1 Month	0.09	-0.12	0.21	-0.01
3 Months	-11.03	-8.24	-2.79	-11.28
Rolling 12 Months	-9.21	-2.84	-6.37	-9.94
3 Years (p.a.)	7.00	6.69	0.31	6.15
5 Years (p.a.)	5.71	5.63	0.08	4.76
Since Inception* (p.a.)	9.76	9.44	0.32	8.66
Since Inception* (cum)	91.85	88.07	3.78	78.87

Source: Ellerston Capital Limited

Securities Held



Securities Not Held



Source: Ellerston Capital Limited

The main positive contributors to this month's performance were overweight positions in core holdings, including Graincorp (GNC +25.6%), Treasure Wines (TWE +4.6%), Fletcher Building (FBU +4.0%), and Star Entertainment (SGR +4.1%).

Having zero holdings in ANZ (ANZ -8.7%), Westpac (WBC -3.6%), Macquarie (MQG -5.0%), NAB (NAB -2.3%) and Suncorp (SUN -5.2%) also had a positive contribution to performance.

The main detractors from performance were overweight positions in QBE (QBE -10.8%), IOOF (IFL -25.1%), JB Hi-Fi (JBH -4.5%), Janus Henderson (JHG -4.6%) and Computershare (CPU -5.3%).

Having a zero holding in BHP Billiton (BHP +11.5%), CSL (CSL +4.4%), Commonwealth Bank (CBA +1.6%), Rio Tinto (RIO +7.1%) and Transurban (TCL +4.8%) also acted as a negative drag on the portfolios relative performance.

[1] Returns are calculated using the Fund's redemption price and are net of fees and expenses. Returns are also calculated on the basis that distributions are reinvested. Returns of the Fund may include audited and un-audited results.
The benchmark was changed to the S&P/ASX200 Accumulation Index on 4 January 2012. Past performance is not a reliable indicator of future performance.
*Since Inception is 4 January 2012.
Source: Ellerston Capital Limited

Fletcher Building

Fletcher Building (FBU) closed the month up 4.0%, but as a reminder, FBU had a tough November after it lowered FY19 guidance by 5% at its AGM, primarily due to a slowdown in the Australian residential market. In our November newsletter we wrote:

> *Overall, we believe the company is controlling what it can control, notwithstanding a much tougher macro backdrop in Australia, and is executing on its enunciated strategic plans… At the same time, the company will aim to divest the Formica business and resume dividends.*

Pleasingly, during the month of December, the company announced that it had entered an agreement to divest its Formica business to Broadview Holding (Broadview) for a sale price of US$840 million ($1,226 million; current book value $1,200 million) or ~10.1 times FY18 EBITDA. We believe FBU has achieved an excellent price in light of current market conditions and new management have again executed on the controllable. The transaction is expected to close by the end of FY19 and is subject to the usual regulatory approvals. Broadview, is a Netherlands based company, with interests in, inter alia, laminates production.

The deal completes the company's articulated strategy to exit non-core businesses (having already sold Roof Tile Group), restores the balance sheet and raises the likelihood of capital management. In relation to the use of sale proceeds, the company has confirmed its intention to reinstate dividends in FY19, commencing with an interim dividend at the half year result and weighting towards the final dividend. Beyond the dividend, while we expect the company to maintain a prudent approach to its balance sheet, we believe there is scope for further capital management initiatives. This process should lead to a re-rating of the stock as the new management team continue to gain credibility in the eyes of investors.

QBE Insurance Group

QBE Insurance Group (QBE) had a poor December, down 10.8%. There was no obvious reason for QBE to have been sold off this harshly. The company provided an update on its new reinsurance program. QBE is expected to have higher exposure to risk losses under the new program but will benefit more in more benign years compared to its current reinsurance program which has lower exposure to risk losses but limited upside. This was in line with ours and the broader market's previous expectations. Some commentators were concerned that the group was more exposed to risk losses under the new program going forward. The company also announced a cost-out program of $130 million. This was a positive announcement but again disappointed some investors, despite the company not providing any guidance on this previously. Also, QBE reiterated its expectations for FY18: the pricing environment continues to be solid, the balance sheet has improved, it was not exposed to losses beyond its exiting reinsurance limits from the catastrophes in 2H18 and that it was on track to meet its combined ratio guidance for FY18. A possible reason for the weakness in the share price could be the fall in US 10-year bond yields and expectations that, if sustained, would not be supportive of the group's investment earnings going forward.

We are comfortable that QBE will deliver FY18 results in line with expectations and that the fundamentals for the stock (pricing and underwriting) remain strong currently.

IOOF Holdings

IOOF Holding (IFL) had a shocking December (-25.1%), capping off a poor calendar 2018 (-49.0%) after being significantly de-rated despite delivering solid results and updates.

What happened?

In early December, APRA took action against IFL, issuing a "show cause" notice saying that IOOF didn't comply with its RSE responsibilities. APRA decided that it would seek to impose additional licences against regulated entities and initiated disqualification orders against five senior executives, including the Chairman (George Vernados), CEO (Chris Kellaher), CFO (David Coulter), Head of Legal, Risk and Compliance (Paul Vine) and the General Counsel (Gary Riordan).

What did it relate to?

It related to an error in an IFL subsidiary called Questor. Questor was dual-regulated, with responsibility for a cash management trust and a super fund and it made an over-distribution in 2009. This was identified in 2011 and IFL told APRA about it then. IFL's initial response meant that super fund members were disadvantaged. IFL then used general reserves rather than corporate reserves (shareholders' funds) to "make good". APRA disagreed with this approach and told IFL as much in 2015. APRA alleges that IFL failed to act in members' best interests. In the end, everyone was "made good" according to IFL. **The amount in question was a mere $1.6 million (today).**

So what does it really likely relate to?

IFL has fought APRA tooth and nail on this matter (and seemingly on all matters where APRA has raised questions). IFL management have argued the dual-regulated structure was allowable and that it was common industry practice at the time. The matter was raised at the Royal Commission. Chris Kellaher, the CEO, performed appallingly when questioned: he came across as smug and smeared that "it was a matter of indifference" to him.

In APRA's announcement, it pointed to a "lack of contrition in relation to the breaches". This seems to be at the heart of the matter. Somehow, IFL's arrogant corporate culture and poor governance have managed to translate an issue ultimately amounting to $1.6 million into very significant shareholder value destruction.

Why were we in IFL?

The transformational acquisition of ANZ's business was to deliver high double-digit EPS accretion, coupled with attractive valuation support. On the riskier matter of likely poor historical advice by ex-ANZ advisors, we thought we had the base covered, as IFL had managed to extract a five-year warranty from ANZ. That is, ANZ would be liable for five years after the deal closed for any mis-selling or losses resulting from poor advice from the old advisors who transferred to IFL. On the basis of earnings accretion, valuation and risk mitigation from mis-selling, IFL looked fundamentally attractive. Since the announcement of the acquisition, IFL has in fact delivered strong earnings inline or ahead of expectations and solid FUM updates.

What's happened since?

Since we bought in, despite solid earnings and FUM updates, IFL has been significantly de-rated by investors. Weaker markets, a de-rating of global wealth managers generally, questions raised at the Royal Commission and finally APRA's disqualification orders, have crushed the share price. The Royal Commission has led to question marks being raised over 'vertical integration', the business model prevalent in financial services. AMP's serious issues raised at the Royal Commission has also led to guilt by association for IFL. This then led to further questions over the likely completion of the ANZ transaction.

Why didn't we act sooner?

After AMP was punished and Chris Kellaher took the stand, we didn't expect such a poor performance by the CEO of IFL at the Royal Commission. We met the company immediately following the Royal Commission and came away feeling that sentiment was already rock bottom and that the company knew it has mis-stepped (but was adamant that it hadn't acted improperly in the past). Despite significant ongoing tail risk being identified (regulation, deal falling over) and an arrogant performance by the CEO, we didn't sell. We held on to the belief of earnings accretion from the deal and valuation support. This assessment has clearly been wrong in the short term. **For the record**: we voted **against** the remuneration report at the AGM citing concerns over the company's past behaviour, performance at the Royal Commission and ongoing uncertainty. Circa 19% of shareholders voted against the remuneration report. IFL avoided a first strike.

How did the market react?

The share price reaction was instant - losing over a third of the company's market capitalisation on the day of the APRA announcement. The reasons previously identified were amplified: unknown risks from the Royal Commission, non-completion of the ANZ transaction, lack of credibility of the senior management team and crystallised regulatory action. Further, there is always a possibility of class action by disgruntled shareholders (even through the amounts relating to the issue in question are relatively small) and for higher remediation costs.

While IFL was not a significant position in the portfolio, we have again reviewed the stock and have decided to continue to hold. We believe that at current levels, the market has priced in extreme negativity and the company is trading at a massive discount to its assessed valuation. Encouragingly, in late December, with a new Chair and CEO in place, IFL and APRA reached an agreement on license conditions for IFL's regulated entity subsidiaries and the announcement saw the stock bounce off its lows. Some of the critical matters identified by APRA have been completed and others are ongoing, with a clear timetable for completion. The ANZ trustees deferred their decision with respect to the ANZ wealth business sale and the trustee's decision and ANZ Bank's decision on the transaction will be critical for IFL's earnings growth. In the event of the transaction falling over, IFL is likely to embark upon a massive share buy-back that would be supportive (given equity was raised at substantially higher prices). However, we acknowledge that the stock could trade at a discount to the sector for some time until the picture becomes clearer.

Banks: Annus Horribilis

We have been zero weighted the four majors and the banks sector has had a horrible year. Total returns for the four major banks have been very disappointing for investors: Westpac Banking Corporation -14.6%, National Australia Bank -12.3%, ANZ Banking Group -9.8% and Commonwealth Bank -4.6%.

Collectively, the four majors detracted 238 basis points from the index. For context, the S&P/ASX 200 Accumulation Index closed the 2018 calendar year down 284 basis points. So the four major banks were a significant negative weight on the index's returns. A number of the negative issues identified previously have come to fruition. While the sector has underperformed and been de-rated, we believe the negative consequences for earnings and returns are yet to play out fully.

At the beginning of 2018, we identified 8 key issues that justified our zero weighting in banks. They were that:

- there was compelling value in other segments of the market;
- top line growth was under both structural and cyclical pressure and expected to be in the low single digits;
- the Australian consumer was amongst the most leveraged in the world;
- credit impairment charges were at historically low levels;
- bank levies and changes to the tax system would hurt margins and constrain credit growth;
- a Royal Commission could be called which would be negative for sentiment and uncover malfeasance;
- ROEs were likely to be declining given cyclical and structural headwinds; and
- the threat from disruptors was real.

All of these factors have played out in support of our thesis. Additionally, just when you thought it couldn't get worse in December, the Reserve Bank of New Zealand (RBNZ) announced that it would be imposing higher capital requirements on banks that operate in New Zealand. This directly impacts the four major Australian banks who have around 88% market share in New Zealand. The RBNZ proposes limiting the extent to which capital requirements differ in New Zealand between banks using the so-called Internal Ratings Based (IRB) approach to calculating Risk Weighted Assets and the Standardised approach. The four IRB banks in New Zealand, also deemed systemically important, are the subsidiaries of the Australian major banks. The implications of the RBNZ's proposal would result in the RBNZ setting Tier 1 capital at 16%, effectively doubling minimum Tier 1 capital. The proposals are to be phased in by 2023.

The banks' Core Equity Tier 1 ratios are currently around 11% on average. Estimates vary on the actual NZ$ value to be raised in total over five years to meet the proposed capital changes, but they currently stand at up to NZ$15 billion. The RBNZ estimates that the additional capital "represents 70% of the banks sector's expected profits over the transition period".

The four majors could raise this additional capital from retained earnings (and lower dividends) or raise fresh capital, or sell assets. It should be noted that the RBNZ proposals are subject to consultation and may change, and importantly, APRA is yet to respond so it's unclear how this proposal will be treated from a consolidated perspective. However, what is clear is that returns will be under pressure and there isn't going to be surplus capital available. Some market observers are currently expecting further buy-backs from ANZ and likely capital management from CBA. Conventional wisdom holds no expectations that dividends are under threat.

Given that the implications of points we raised at the start of the year are yet to play out, we see further fundamental deterioration putting pressure on bank earnings and returns going forward. The additional capital requirements in New Zealand increase pressure on banks' capital. While the de-rating has been significant (and we are mindful that some investors might see attractive value following that de-rating), we remain cautions on earnings and returns and suggest more downside share price risk.

FUND ACTIVITY

The Fund has been highly active during December repositioning and refreshing the portfolio, with the selloff providing some great long term buying opportunities.

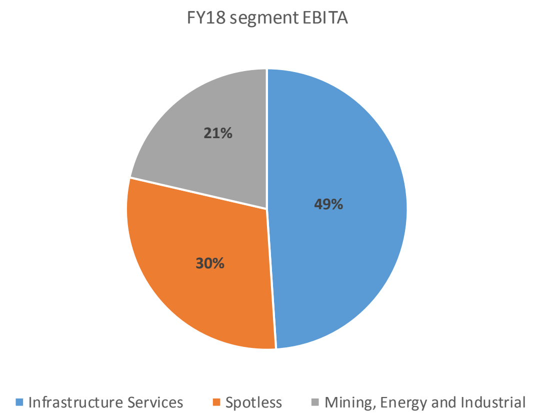
new stocks added	stocks exited
• Downer EDI	• None
• Aristocrat Leisure	

positions increased	positions decreased
• BlueScope Steel	• Star Entertainment Group
• Nufarm	• Tabcorp Holdings
• Computershare	
• QBE Insurance Group	
• Janus Henderson Group	
• Fletcher Building	
• Woodside Petroleum	
• Treasury Wine Estates	

Downer EDI

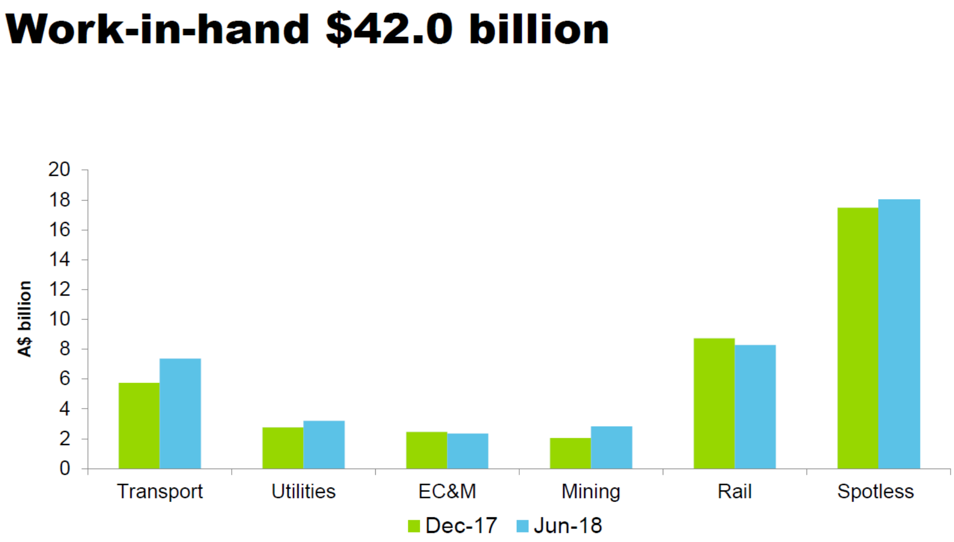
During the month we introduced Downer EDI (DOW) to the portfolio following its sharp share price retracement. Downer is a leading services provider in Australia and New Zealand with a market capitalisation of ~$4 billion, with main business lines in:

- Infrastructure Services (Transport, Rail, Utilities)
- Spotless (Facilities Management)
- Mining, Energy and Industrial



Source: Company Reports

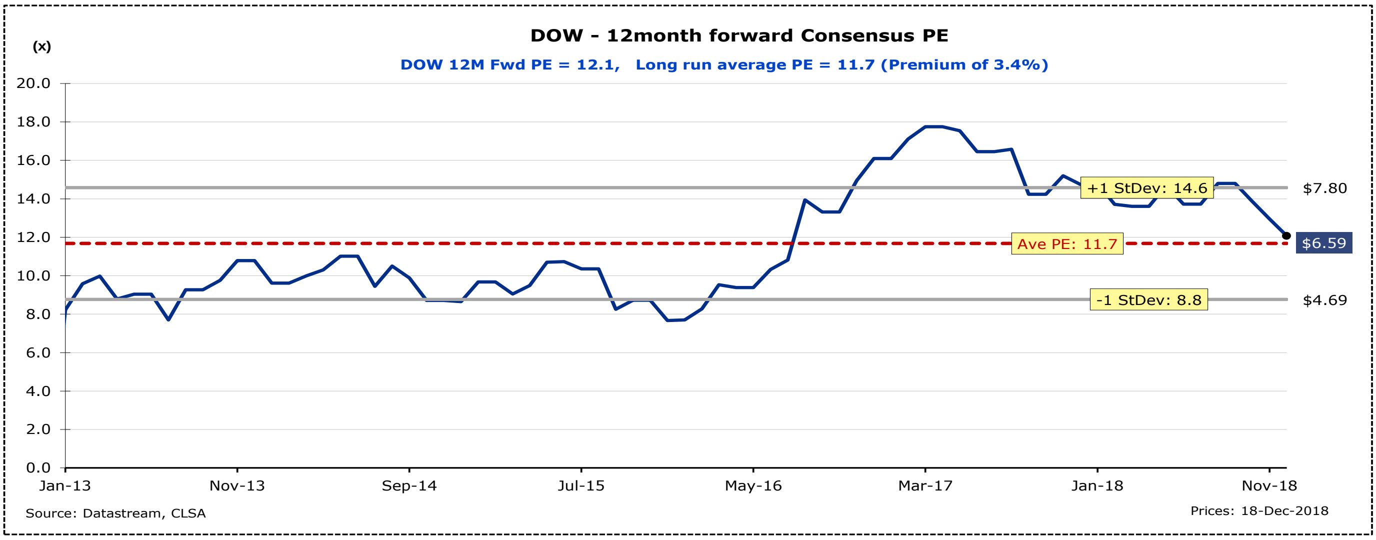
We believe Downer is uniquely positioned to benefit from the booming Australian infrastructure spend over the next few years with the majority of spend yet to be awarded/contracted. State and Federal governments have committed to spend $169 billion on Infrastructure over the next four years (FY19e – FY22e), with New South Wales ($66 billion), Victoria ($31 billion) and Queensland ($29 billion) representing almost three-quarters of the total spend. This should bode well for Downer's growing work-in-hand book.



Source: Company Reports

Spotless – an issue that's now created an opportunity

In March 2017, DOW issued over $1 billion of equity to acquire Spotless Group. The acquisition surprised the market and the company has de-rated significantly from a peak P/E of ~18x back towards its long-term average of ~12x.



The market remains sceptical of Downer for two main reasons:

- The Spotless acquisition does not make strategic sense and will destroy value;
- During the acquisition review, a problematic contract with the Royal Adelaide Hospital (RAH) was identified. The resolution with the SA Government is dragging and testing investor's patience.

We have carefully considered the above concerns and feel the market has overstated the financial impact and is ignoring a company that is very well positioned to capitalise on significant infrastructure spend and improving industry structure. In summary we believe:

- The Spotless acquisition makes strategic sense as it provides customers with a broader, more integrated service offering and enhances its ability to benefit from the continued trend towards government outsourcing. There is already tangible evidence of synergies with over $100 million of work won through joint bidding;
- DOW should resolve the commercial and operational issues pertaining to RAH with the (newly elected) SA Government, as it is in the best interests of both parties to do so. Importantly, in the event that DOW is unsuccessful, it has estimated the present value of losses would be $93.8 million or an insignificant 16cps; and
- Spotless is characterised by long term contracts which is reflected in the ~$18 billion in work-in-hand. Well managed, this will provide DOW with a less cyclical and more predictable business which over time should allow the company to re-rate towards a market multiple.

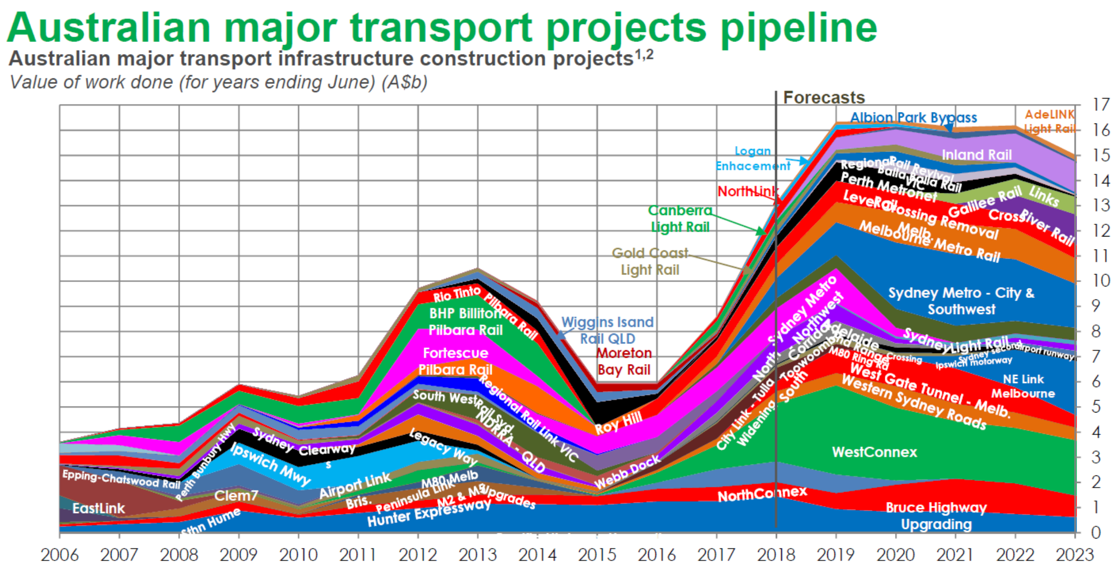
Downer a company for now and tomorrow

We believe Downer is uniquely positioned to benefit from the key structural themes of:

- Increasing urbanisation;
- Growing population;
- Technology proliferation; and
- Government outsourcing.

As can be seen in the diagram below, **Downer's Transport and Infrastructure** business should benefit from the growth in road construction as well as significant government investment in public transport, particularly in light and heavy rail. The telecommunications market should stay buoyant over the next few years, while growth in utilities will be driven by wind and solar projects in Australia and New Zealand. Population growth and government outsourcing will drive growth in social infrastructure opportunities across most Australian states in health, education and other government services, such as Defence. We also believe the controversial cost blowouts with the Sydney Light Rail (Acciona) and Lend Leases' issues within its Engineering business will improve industry margins and terms of business in future tenders, which should ultimately benefit Downer.

In relation to the **Mining, Energy and Industrial** business, while there has been a decline in oil and gas construction as the major LNG builds come to an end, Downer is growing its asset services business in this sector. With 25 process trains soon to be in operation around Australia, there are significant opportunities in shut-downs, turnarounds and general maintenance. There will also be some further investment in greenfield and brownfield iron ore projects.



Source: Company Reports

Sale of Mining would also drive a re-rating?

According to the press, there is potential interest in Downer's Mining operations (book value ~$500 million). While a successful sale would enhance the investment case, it is not fundamental to our attractive valuation and would be a bonus. Contract mining is capital intensive and cyclical and a successful exit would improve group ROFE, potentially leading to capital management.

Balance sheet and cash flow

Downer's balance sheet is sound, with net debt of ~$770 million (FY19E), implying net leverage of ~0.9 times and interest cover is ~10.3 times. The company has ample liquidity of $1.5 billion. Given the nature of Downer's business, its cash flows are stable, with the company achieving seven years of cash flow conversion in excess of 88% of EBITDA.

Conclusion

In our view, Downer is another case of the market ignoring "good news" and magnifying the impact of "bad news". This has compressed the multiple and sees the company trading on ~12 times FY19E PE, which appears very cheap when compared to its closest peer, CIMIC Group, at ~18 times. As investors who like to avoid crowded trades and trust long-term valuation, we believe DOW represents a clear buying opportunity. As the market warms to the "good news" and the company deals with the "bad news", we expect the stock to re-rate materially.

Activity centred on increasing the Fund's position in high conviction core holdings such as BlueScope Steel (see comments in section above) and Treasury Wine Estates that continued to be de-rated despite reiterating guidance and executing well. These stocks looked materially oversold relative to our longer-term assessed value. We also kept adding to the Fund's position in relatively new holding Computershare, to achieve a more meaningful weighting in the portfolio.

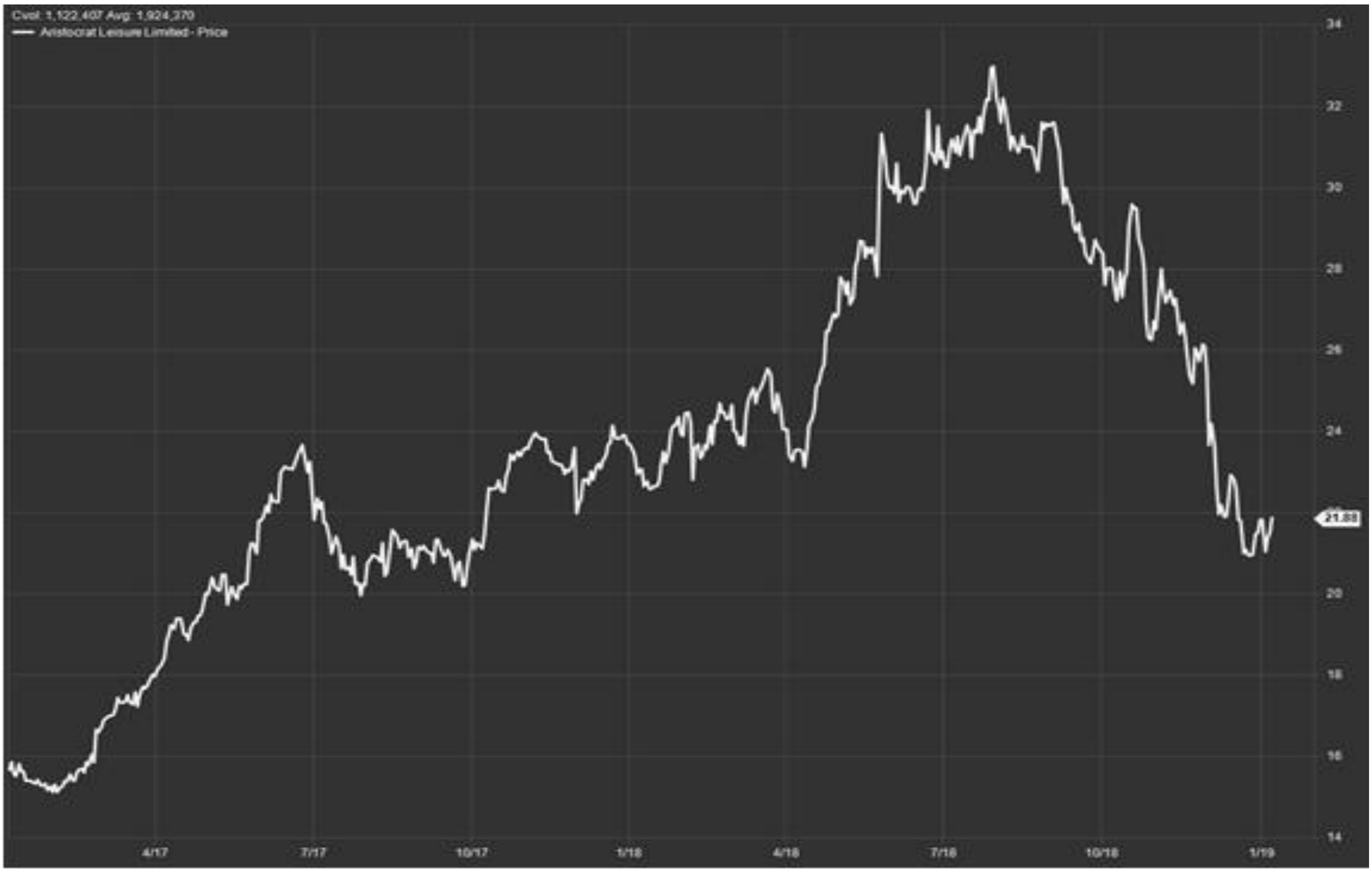
Additionally, we culled the exposure in gaming stocks Tabcorp Holdings (TAH) and Star Entertainment Group (SGR).

We reduced the size of our TAH position in November. We continue to be attracted to the sustainable growth trajectory for the Lotteries business where a favourable competitive landscape has been secured, digital migration is still at an early stage and a refresh and repositioning of the product portfolio will continue. However, competition in the wagering industry has stepped up as peers rebrand, merge and attempt to win market share ahead of the commencement of the POC tax in the key East Coast States from 1 January 2019. This has tempered our view.

The capital light expansion strategy SGR is employing with the help of its Chinese investment partners is a key attraction. As is the realisation of benefits from the recent refurbishment of the Gold Coast and Sydney facilities, likely approval for the Chinese partners to increase their stake in SGR from 10% to 20% and potentially favourable outcome from the construction tender for the QW project. However, signs that growth in the key VIP market is cooling led us to reduce exposure to this name in November.

Aristocrat Leisure Limited

Aristocrat made a return to our portfolio this month following a savage correction in its share price from ~$32 in July. We haven't been a shareholder since former highly regarded CEO, Jamie Odell, left the organisation. But compelling value has re-emerged in a stock that has successfully established itself as a top tier manufacturer and distributor of slot machine games in the casino and digital markets.



Source: Factset, Ellerston Capital Limited

What's happened?

The recent earnings result for FY18 was the first mis-step from Aristocrat management in a long time. The negative earnings surprise came from its digital business. A temporary lull in new game releases slowed revenue momentum. Aristocrat announced a material step up in marketing investment in FY19 to reignite growth and support the release of new game titles. The revenue benefits will lag the additional investment and the market seems less willing to give the relatively new leadership team the benefit of the doubt.

The land-based business, upon which the original turnaround in Aristocrat's performance was based, continues to deliver solid revenue and earnings growth in line with expectations.

Why buy it now?

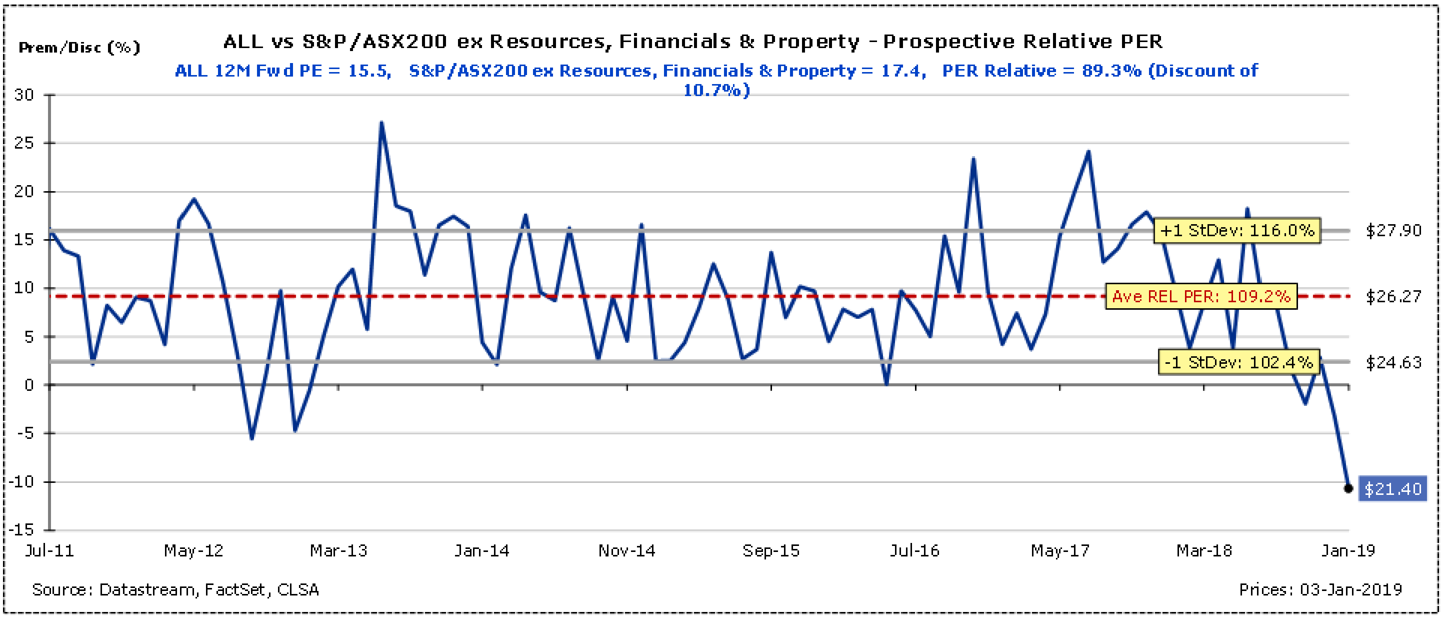
As we have previously learnt, in the slot machine and game industry, value is an illusion when the product cycle has turned and players and customers become more excited about a rival's product. Operating leverage is significant, so changes in customer demand (revenue) will have a large impact on earnings. But Aristocrat's recent FY18 result was a short term hiccup in its earnings growth journey, not a sign of a turn in the product and earnings cycle. Earnings will continue to grow in coming periods.

More specifically, here's why the share price decline represents an attractive entry point.

- Aristocrat's Digital business is a market leader in an industry that is set to grow at rapid rates (circa high single digits) for several more years. Its highly successful product, Lightning Link, is only just being rolled out in the digital market. Dragon Link will follow. The step up in customer acquisition costs, a key concern for the bears, should deliver a revenue uplift consistent with past experience, albeit the monetisation associated with that spend will lag the cost impost.
- The roll out of the Lightning Link and the Dragon Link franchises in the US land-based casino market still has some way to run. Game performance remains very strong. So Aristocrat will continue to build its base of recurring revenue 'gaming operations' machines at attractive fixed fee-per-day rates.
- New products in market adjacencies in the US (for example, class 2 video outside Oklahoma, class 3 stepper product) continue to gain player and customer traction. Other adjacencies offer similar opportunity for revenue growth, such as video lottery terminals and bar top machines.

- The Australian business (which is circa 17% of the earnings pie) is unlikely to see much growth from here, but strong game performance compared to key peers means market share can be sustained at a relatively high level in the near term. A material decline in the earnings contribution from the Australian business is not imminent.
- The non-US international land-based business is likely to be a modest headwind to growth in the short-term as it cycles some large new casino openings, but that will reverse in FY20, at the same time replacement demand should start to improve in markets like Macau.
- Aristocrat continues to spend record amounts on R&D in the form of design and development of new games and product to support the much larger installed base.
- Cash flow generation is very strong. Gearing will fall dramatically over the coming 12 months, opening up potential for ongoing investment in new game and machine development, additional customer acquisition spend in the digital business, higher dividend payments, share buy backs and/or more value accretive acquisitions where identified (most likely in digital to further scale up the business).
- The valuation is compelling (PER of just over 16 times consensus FY19 earnings), given earnings will continue to grow in future periods, albeit at slower rates than recent history. In the past, Aristocrat only traded on lower earnings multiples when the product cycle had peaked and market share and earnings were in a period of steady decline. That is not the case here. Earnings will continue to increase (consensus estimates imply high teens growth in FY19 and low teens growth again in FY20). Plus the quality of the earnings stream – more recurring revenue – is better than it has ever been in the company's history and deserves a valuation premium.

You should expect us to continue to increase our exposure to this name at current or lower share price levels.



Origin Energy – Continuing evolution and why we are still keen

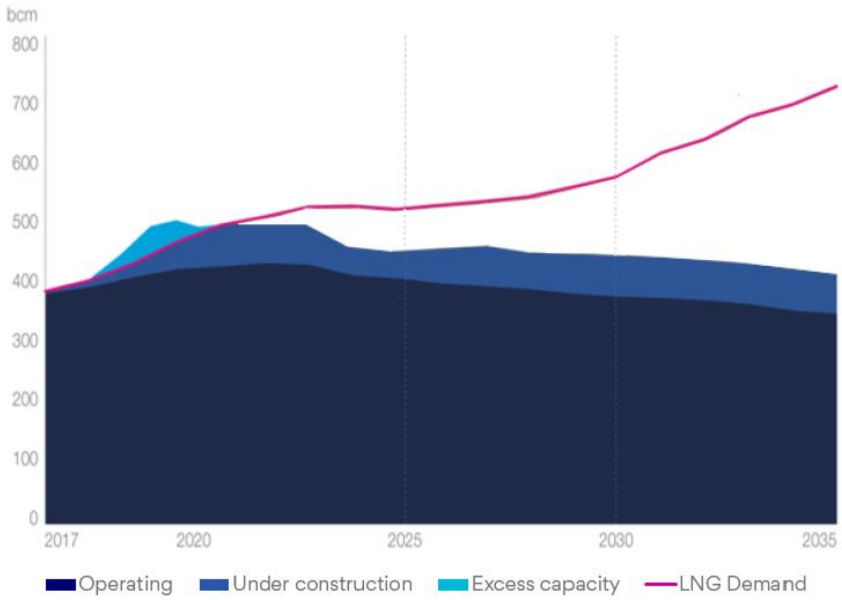
Origin Energy, hosted its annual strategy day in December outlining cost out initiatives across its Energy Markets and Integrated Gas operations. In addition, it revealed plans to restructure more than $2 billion of corporate debt, delivering significant savings and reinstate its dividend from 1H19, a key milestone for the group and a fundamental platform of our investment thesis.

Cost out

Origin outlined a substantial $150 million cost out programme in Energy Markets by FY21, from a reported FY18 cost base of A$1,221million. Importantly the cost out target will absorb any inflation on the existing cost base and help drive future profitability. Whilst part of this benefit may be offset, if a default market offer (DMO) is enforced by the regulator (as anticipated by the market) we believe ORG will be in a position to mitigate the impact through lower churn, reduced marketing costs and winning new customers.

Cost and efficiency gains at ORG's APLNG asset continues to improve, with the company forecasting drilling costs to fall to A$1.1million per well by June 2019 and operating costs to fall to A$1/GJ over the same timeframe. Importantly distribution breakeven has fallen to US$40/boe and is expect to drop to <US$35 over time. APLNG holds Australia's largest CSG reserves base and has excellent proximity to a growing appetite from Asia with an impressive demand profile.

Global LNG supply and demand



Source: McKinsey, HIS Vintage, Origin Energy

Capital Management

Origin is pausing investment in generation, due to satisfaction of renewable energy target (RET) and investment uncertainty stemming from a lack of clear government policy. Low capex will provide substantial free cashflow over the next 5 years. We believe ORG could generate A$2 billion of annual free cash, which gives the group huge flexibility for capital management. ORG has announced it will resume dividend payments from its 1H19 results with a full policy, based on a payout ratio as a function of free cashflow, to be announced with its FY19 results.

Whilst debt levels are falling rapidly, we feel that the company will adopt a conservative payout 50% ratio, which would imply a dividend of circa 50 cents and a dividend yield of 7%. This would allow for approximately $1bn of debt to be repaid on an annual basis. On a P/E of 10.3 times FY19 re-based earnings, we believe that the shares are mis-priced and at $6.50, represent excellent long term value.

FUND STRATEGY AND OUTLOOK

World markets (including Australia) have entered 2019 in a more fragile state than was thought likely 6 months ago. Stock markets are clearly being torn between the competing forces of fear and fundamentals that are in reasonable shape. Whilst the world economic growth outlook still looks robust, forecast at ~3.7% growth for 2018 and 2019, many risk assets appear to have peaked. US market indicators continue to suggest that risk-appetite, inflation expectations and confidence in the US economy are all falling.

Investors are rightly concerned with the issues 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), coupled with sub trend growth in Europe, tighter monetary policy and more prominently, 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.

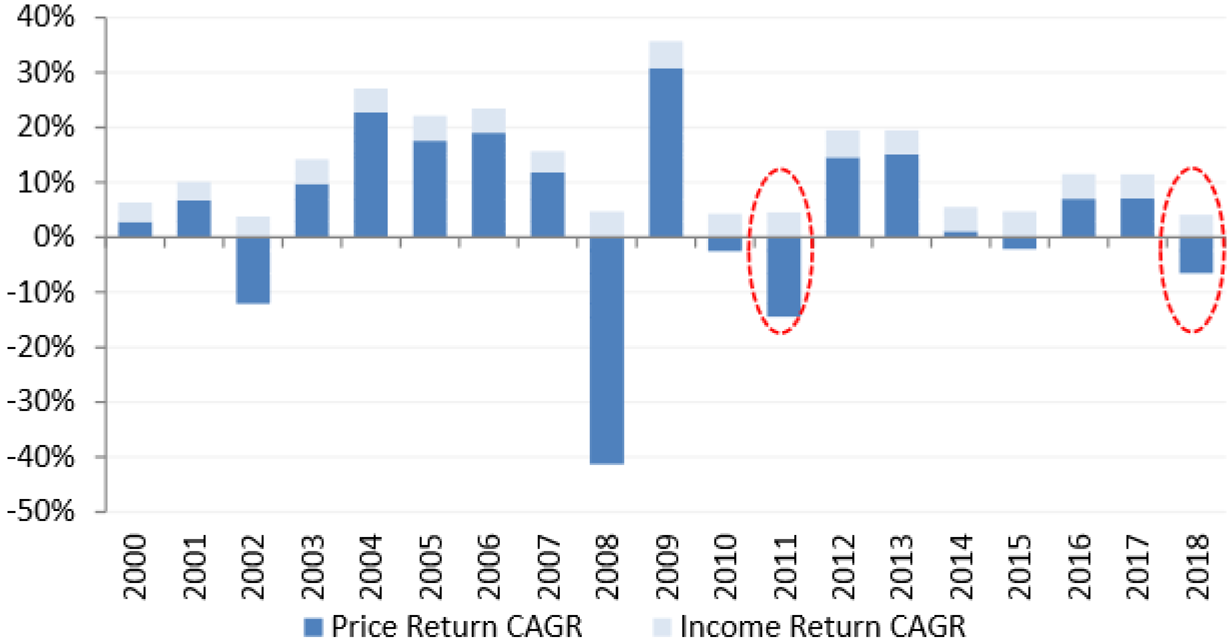
President Trump wants low rates, a weaker US dollar and higher deficits to help fight his trade war with China and is willing to undermine the Fed to get his way on rates. Trump's inclination is towards protectionism in order to 'make American great again'. The risk of a political miscalculation is high, especially given the precariousness of investment markets and a slowing global economy. The Fed meanwhile is concerned that QE has fuelled asset bubbles and a substantial increase in debt levels, and that it has little policy ammunition left to fight these distortions. Investors are genuinely worried over the potential for a monetary policy misstep by the Fed.

It makes for a very volatile investment environment in 2019 as we move from a world of QE to QT. The recent correction in many stock prices is presenting plenty of fresh opportunities. We have been selectively buying during the month's sell-off and have also added fresh stocks to the portfolio as mentioned in the activity section above.

Major uncertainties facing investors that we have previously highlighted still prevail. Domestically, these include the second-order effects of the above macro drivers, along with sharply slowing credit growth, an indebted consumer, fear of a harder economic landing and a pending Federal election this year. 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.

The recent pull back in Australia's equity market has resulted in multiples for the index tracking lower. **The ASX 200 Index is now trading at a more attractive 14.0 times**, well below the peak reached in August 2018 of 15.9 times. Even the **Industrials ex-Financials have de-rated from a peak multiple of 22.2 times to 19.0 times**. However, this still remains more than 1 standard deviation above the long-term average multiple of 16.7 times. Earnings revisions have been negative and have deteriorated through the recent AGM season.

The ASX delivered its first negative calendar year return since 2011



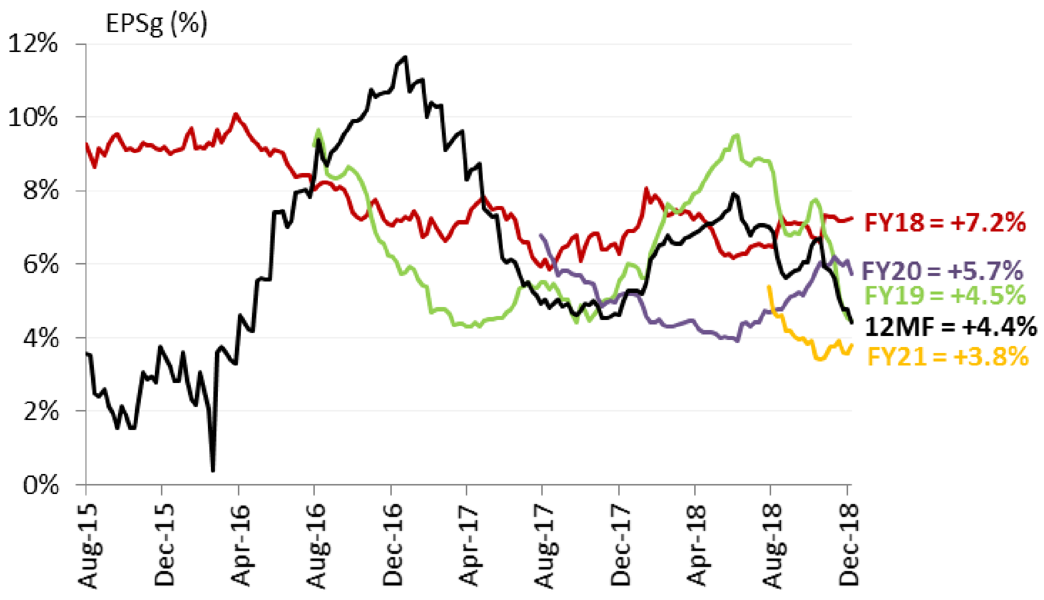
Source: RIMES, Morgan Stanley Research, December 2018.

The "global growth scare" in 2019 is likely to come from a full blown trade war and the consumer in China spending less.

The Fed's more dovish tone has seen bond yields fall sharply and this may provide a short-term fillip to risk assets to enjoy periodic relief rallies. However, concerns remain that after a 10-year bull market in risk assets, we might be at peak earnings and profitability, making stocks trading on elevated multiples extremely vulnerable to a further correction. In the US, the consumer looks fine, but trade tariffs are starting to impact the outlook for corporates when sifting through the recent commentary from executives in 3Q.

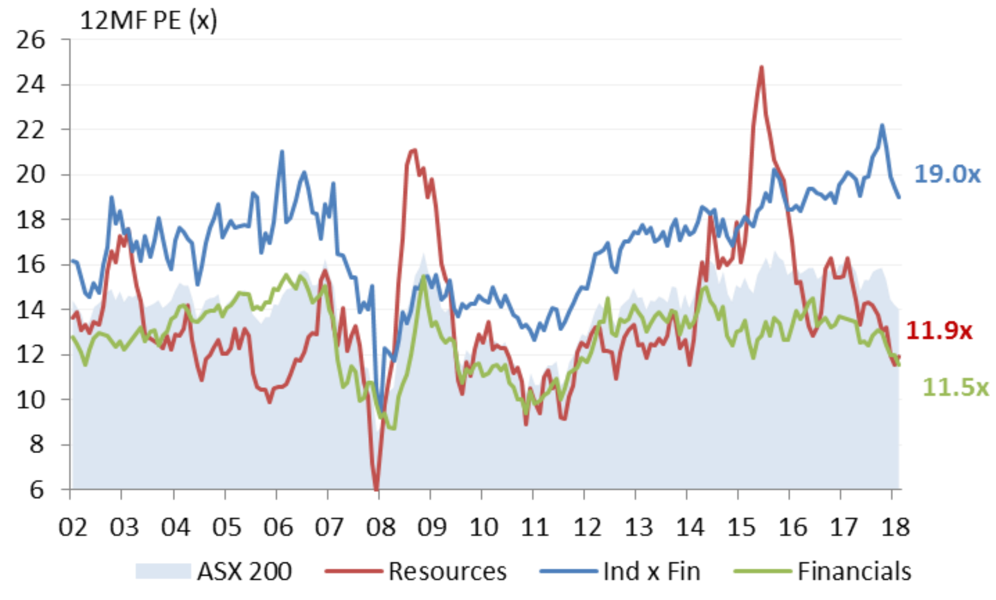
The 3Q18 appears to have been the peak in the S&P 500's EPS growth rate at approximately 26.5%, while 4Q18 is tracking at 15.7%, with one year forward earnings decelerating to around 9.0%.

The chart below shows that earnings expectations domestically have been marked back to mid-single digits.



Source: Morgan Stanley Research, December 2018

Based on valuations, the Australian market now looks much more reasonable.



Source: RIMES, Morgan Stanley Research.

We have again provided our segmented portfolio positioning below:

- **Quality Franchises/Defensive characteristics**

  Solid companies with strong/leading market positions and credible management with good balance sheets.

  Treasury Wines, Tabcorp, Challenger Ltd, Aristocrat and Computershare

- **Quality Business, but cyclical in nature facing certain headwinds**

  Companies with strong market positions and strategic assets, but very sensitive to economic conditions/seasonality/weather.

  Graincorp (received a takeover proposal) and Nufarm (experiencing the driest conditions for many years), JB Hi-Fi, Downer EDI and Star Entertainment

- **Turnarounds**

  Sound businesses that have historically generated poor returns, have been badly managed, under-earned versus their potential, are in transition, and where we think earnings/returns will improve over the medium-term.

  QBE, Fletcher Building and Healthscope (received a renewed takeover proposal)

- **Deep Value Cyclical/Material and Energy Plays**

  Stocks trading at discounts to NPVs, with growth optionality, at a turning point in the cycle.

  BlueScope Steel now trading on 3.4 times EV/EBITDA and net cash sitting on its balance sheet (with over 200m t of Chinese higher cost capacity taken out of the system), Woodside Petroleum and Origin Energy

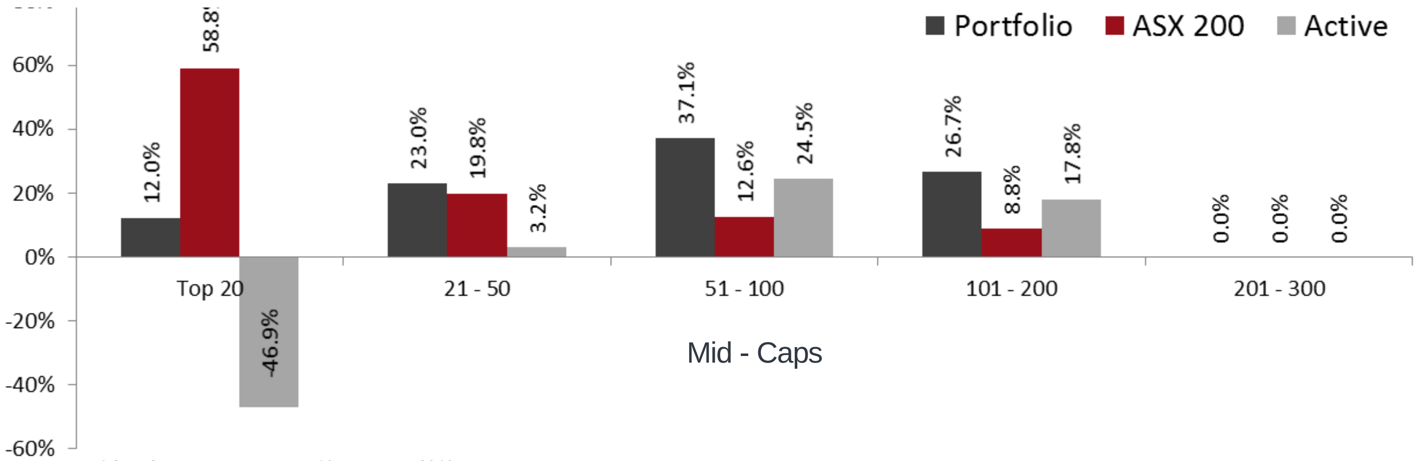
- Still **Zero Banks** (a position held for some years now), despite their underperformance versus the broader market for the past three years.

Warm Regards,

Chris Kourtis
Portfolio Manager

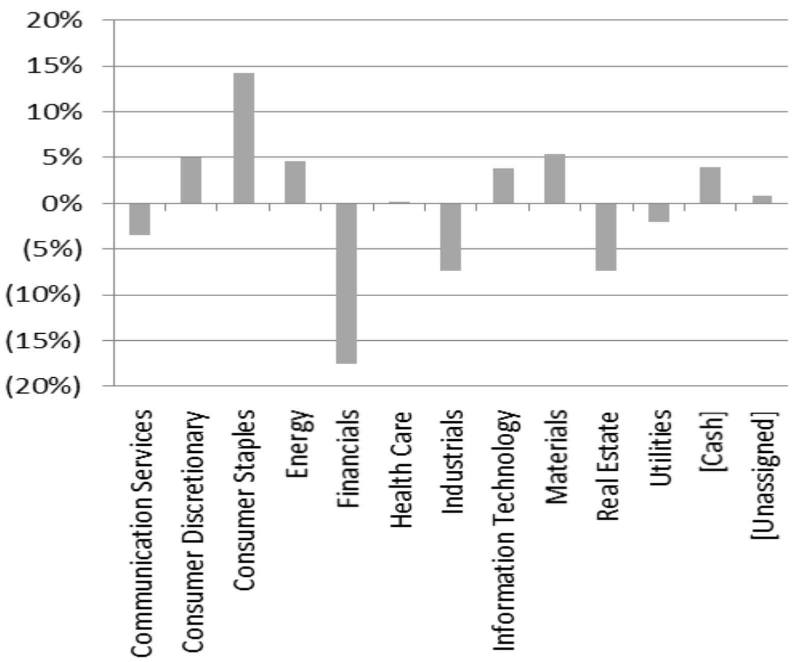
PORTFOLIO FEATURES

Size comparison Chart vs ASX 200



* Size Comparison Data as at 18 December 2018
Source: Bloomberg, Ellerston Capital Limited

Active Sector Exposures*



Source: Ellerston Capital Limited

TOP 10 HOLDINGS**
BLUESCOPE STEEL
COMPUTERSHARE
FLETCHER BUILDING
GRAINCORP
HEALTHSCOPE
JB HI-FI
NUFARM
ORIGIN ENERGY
QBE INSURANCE
TREASURY WINE ESTATES

ASSET CLASS EXPOSURES

EXPOSURE (% OF NAV)	Net
EQUITY	95.29
LONG OPTION	0.0
SHORT OPTION	(20.54)
EFFECTIVE CASH	25.25
GRAND TOTAL	100%

* Active sector exposures are determined by subtracting fund sector weights from benchmark weights. Positive percentages represent over-weight sector exposures relative to benchmark and negative percentages represent under-weight sector exposures relative to the benchmark.

** Top 10 Holdings are listed in alphabetical order.

ABOUT THE ELLERSTON OVERLAY ASF

The Fund aims to achieve its performance objectives by adopting a fundamental "bottom-up" investment approach to stock selection whilst delivering additional income where possible, through option strategies.

Because of the nature of the strategy, at least 75% of the Fund's exposure is aligned to the portfolio of the Ellerston Australian Share Fund.

The 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.

FUND FACTS

STRATEGY FUNDS UNDER MANAGEMENT	$211 MILLION
FUNDS UNDER MANAGEMENT –UNIT TRUST	$25 MILLION
APPLICATION PRICE	$1.0209
REDEMPTION PRICE	$1.0159
NUMBER OF STOCKS	18
INCEPTION DATE	4 January 2012

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