Ellerston Capital

Ellerston Australian Market Neutral Fund

Performance Report | February 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	-0.72	-4.13	-9.11	-13.20	-1.03	3.65	5.43
RBA Cash Rate	0.11	0.37	0.74	1.50	1.54	1.83	1.93
Alpha	-0.83	-4.50	-9.85	-14.70	-2.57	1.82	3.50

Source: Ellerston Capital Limited

	Jan	Feb	Mar	April	May	June	July	Aug	Sep	Oct	Nov	Dec	YTD
2019	-0.92	-0.72											-1.63
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	64%	Net Equity Exposure	+24%
No. Relative Value positions	97	Gross Portfolio Exposure	194.4%
No. Special Situations	28	Correlation Coefficient (vs ASX 200 Accum)	0.73%
Beta Adjusted	-2.4%	Net Sharpe Ratio (RFR = RBA Cash)	0.77

PERFORMANCE

The Fund returned -0.7% in February, underperforming the benchmark return of +0.1% in the period. Despite a takeover bid for Ruralco (+47.5%), long held as part of a rural-services pair with Elders (-1.0%), the net contribution from Relative Value was negative in the period. Special Situations added almost +0.6% (gross) to performance in the month.

Net exposure was +24% with a beta-adjusted net of -2.4%. Gross exposure closed the month at 194.4%.

Our patience with our Ruralco investment was rewarded in February with the company receiving a takeover bid from Nutrien (+5.1%), the world's largest provider of crop inputs and services. The consideration of $4.40 represents a 44% premium to the Ruralco share price and allows for part of the payment to be made as a fully-franked special dividend, further increasing the value beyond the cash amount. As previously mentioned, we have long believed in the merit of a merger between Ruralco and Elders and the move from Nutrien (who owns Landmark in Australia) was unexpected, but obviously welcomed.

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	$367.1M
Liquidity	Daily
Application Price	$0.9548
Redemption Price	$0.9500
Management Fee	1.20%
Buy/Sell Spread	0.25%
Performance Fee	20% of outperformance
Firm AUM	Over $5 billion

A paired position between Infigen Energy (+10.0%) and AGL Energy (+1.6%) added value in the month, with both companies reporting on their 1H19 performance. Infigen reported strong results, with underlying NPAT above consensus forecasts and the company reiterating their commitment to capital management, expected to be in the form of dividends. AGL also delivered a significant boost to NPAT, however the market was disappointed that a buyback was not announced. Even with the recent rally, Infigen continues to trade a significant discount to AGL, with a FY19 Price/Earnings ratio of 9.3x, compared with AGL at 13.4x.

A newly-established long position in Link Administration (+7.6%), hedged with a short in ASX Ltd (+9.5%) was also a positive contributor in the period. Link provides administration services through technology and was a part of the consortium that recently bought PEXA – an online property exchange network that allows for settlements to occur electronically. It trades at a FY19 Price/Earnings ratio of 17.4x. ASX is the operator of the Australian Stock Exchange and despite modest growth, trades on an eye-watering FY19 Price/Earnings ratio of 27.1x. It also has its own online property exchange network, called Sympli Australia.

Our long position in land developer Peet (-10.8%) hampered performance during the month with the stock underperforming other REIT peers in the period. The company announced a solid 1H19 financial result with NPAT and EPS increasing 5.4% and 6.0% respectively, while gearing remains towards the lower end of the 20% to 30% range. The previously-announced buyback remains active, with the stock trading at around a 20% discount to NTA. Despite the fundamentals, the market remains wary of residential property exposure and the Peet share price suffered accordingly.

The spread between the Australian and UK listings of BHP Billiton (+6.9%) and Rio Tinto (+10.5%) widened in the month, detracting from the performance of the Fund.

Our position between merger candidates Eclipx Group (-11.4%) and McMillan Shakespeare (-21.0%) added to performance, with both companies fronting the market during the period. Eclipx held their AGM early in the month and reiterated their commitment to the merger, as well as reconfirming FY19 guidance. Later in the month, McMillan reported on their 1H19, missing consensus expectations by 7% and leading to a fall in their share price which also dragged down Eclipx. McMillan provided little new information on the merger, saying they are still working through the implications from the Eclipx downgrade in January and will provide a further update in “due course”. We continue to believe a deal is strongly in the interest of both parties and the transaction will close, on announced terms, before June 30.

Superloop (+5.3%) reported on their 1H19 during February, with the result difficult to assess, due to the adoption of a new accounting standard that changes the way revenue from contracts are recognised. The general consensus was that the result was a miss, however the magnitude of the miss was unclear. Along with the result, the company also announced a $31m capital raising to reduce net debt and provide cash for further infrastructure investment. While the result was disappointing, the infrastructure build is now complete and the company is poised to capitalise from the rapid growth in data traffic within Asia-Pacific. We participated in the equity raise, which was issued at a 19.6% discount to last.

Pro-Pac Packaging (-24.4%) also announced their 1HFY19 results in the month, with the numbers in line with the previously downgraded forecasts, released in November last year. The stock traded lower however, dragged down by the share price performance of listed-peer Pact Group (-23.2%), which once again missed consensus estimates and cut their dividend to nil. Australian packaging companies are struggling at the moment, with a weak Australian dollar and high resin prices, although since the end of December, the price of resin has started to retrace.

Our long position in Johns Lyng (+21.9%) once again added value in the period, with the share price continuing to benefit from the hailstorms in December, as well as the more recent flooding in Townsville. The company reported its 1HFY19 results during the month, with management upgrading EBITDA by 8% for the full year, before any impact from the Townsville floods. Importantly, revenue from Business as Usual (excluding Catastrophe revenue) increased almost 16% vs. pcp, a direct result of contracts that were awarded earlier in 2018.

ACTIVITY

Relative Value – Gross Contribution -1.21%

Following a significant fall in the share price of Stockland (-7.4%), we established a long position, hedging the exposure with a short in Mirvac (+7.1%). While we remain wary of companies with residential property exposure, the spread between the two companies had widened to what we believed was an extreme level. Despite the noise around reforms to negative gearing, there is the genuine possibility that a Federal government First Home Buyers grant may be simultaneously reinstated, going someway to offset those reforms. There is also the chance that there are 1 or 2 interest rate cuts in 2019, which could also help slow the decline in house prices. In the end, the spread between the two stocks had reverted by the end of the month and the position was closed.

A selldown by a large institutional shareholder of Contact Energy (+4.8%), provided an opportunity to establish a long, hedging the position with NZ-listed peer, Meridian Energy (+4.8%). The NZ electricity market is entering a new phase of modest demand growth, having just cycled off a period of generation overbuild. We believe wholesale power prices will remain at elevated levels over the medium term due to: (1) the re-commissioning of the 4th potline at Tiwai, (2) the growing EV fleet, (3) the conversation of carbon fuelled heat creation to electricity, and (4) the NZ governments 2050 zero carbon goal. Whilst positive for the whole industry, Contact will benefit more from demand growth as their 3000GWh of geothermal options are the last meaningful baseload renewable generation in NZ. Within the sector, we continue to prefer Contact which trades on a 6.1% dividend yield, over Meridian Energy which trades on 5.6%.

As discussed earlier, a paired position was established between diversified financials Link Administration and ASX Ltd after both companies announced their 1H19 results. While Link's 1H19 result indicated a modest increase in costs, most sell-side analysts remained positive on the name with 9 buys and 1 sell recommendation. We felt the share price reaction immediately following the result was overdone and took advantage of the share price weakness, hedging the exposure with a short in ASX. The spread narrowed quickly and the position was unwound by the end of the month.

Spark Infrastructure (-3.3%) surprised the market in February, with a cut in their distribution guidance based on the outcome of a long-running tax litigation case. Losing the case means that the current unused tax loses will be used up and Spark incurred a $270m non-cash impairment on the carrying value of their investment in SA Power Networks. The market sold the stock down aggressively and we capitalised on the fall, hedging the long exposure with a short in Ausnet Services (+5.2%). Within 2 weeks the spread had narrowed and we were able to close the position with a modest profit.

A capital raising in Viva Energy REIT (+7.1%) during the month provided an opportunity to cover our short positions at a discount to the market price. The $100m raise was used to partly finance 8 acquisitions and provide headroom for future growth. The liquidity event facilitated the unwinding of two paired positions that featured Hotel Property Investments (+2.9%) and Centuria Industrial (+6.5%) as the longs.

With spreads narrowing, we continued to reduce our exposure to the Village Roadshow (+4.9%) – Ardent Leisure (+19.9%) pair and completely exited paired positions between Aventus Retail Property (+5.7%) and Dexus (+4.7%), Caltex (+6.6%) and Viva Energy (+31.0%), and Capitol Health (-29.1%) and Integral Diagnostics (-1.5%). We also reduced our exposure to the Infigen – AGL Energy pair.

Special Situations – Gross Contribution 0.59%

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.

During the month, NZ-listed PGG Wrightson (+5.2%) received clearance from the NZ Commerce Commission for the sale of their seeds business to Danish seeds giant DLF. Following the approval of the ACCC and applicable South American regulatory bodies, only the approval of the NZ Overseas Investment Office remains outstanding. If approved, the company intends to pay a capital return of NZD0.39 per share, which implies the remaining rural services business is trading at an EV/EBITDA multiple of <4x. We continue to believe that Elders will acquire the remaining rural services business, especially given the recently announced Nutrien bid for Ruralco. We remain confident that the remaining approval will be granted in the near term and increased our position in PGG Wrightson accordingly.

We reduced our holding in IVE Group (+2.3%), Pro-Pac Packaging (-24.4%) and Paragon Care (-21.2%) and completely exited our position in Redbubble (+4.1%).

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	56.0%	-47.4%	8.6%
Financials	56.0%	-47.4%	8.6%
Builders	2.4%	0.0%	2.4%
Consumer Disc	2.7%	-0.1%	2.6%
Consumer Staples	3.3%	0.0%	3.3%
Contractors	0.0%	0.0%	0.0%
Gaming	0.0%	0.0%	0.0%
General Industrials	5.8%	-1.7%	4.0%
Health Care	2.8%	0.0%	2.8%
Information Technology	1.5%	0.0%	1.5%
Infrastructure	0.0%	0.0%	0.0%
Materials	0.0%	0.0%	0.0%
Media	3.4%	-0.5%	2.9%
Telcos	0.0%	0.0%	0.0%
Utilities	3.1%	-1.4%	1.7%
Industrials	25.1%	-3.7%	21.4%
Bulk Metals	24.0%	-24.2%	-0.2%
Energy	0.1%	0.0%	0.1%
Gold	0.0%	0.0%	0.0%
Resources	24.0%	-24.2%	-0.1%
Hedge	0.0%	-6.0%	-6.0%
Index	0.0%	-6.0%	-6.0%
Total	105.1%	-81.2%	24.0%

Source: Ellerston Capital Limited

MARKET COMMENTARY

Market Overview

In February, global equity markets continued to rally. Developed Markets, led by Australia, rose 3.4% and outpaced Emerging Markets, up 1.1%. Performance was supported by expectations of a positive outcome from the trade talks between the US and China. In fact, on 24 February, President Trump announced that the US would postpone an increase in tariffs on goods from China due from 1 March because of "substantial progress" in trade talks.

USA

Politics in the US continued to be unpredictable, with President Trump declaring a national emergency on 15 February over border security, in an effort to get more funding for his wall on the US-Mexico border. Markets however shrugged off the political noise from Washington and focused instead on a likely positive outcome from the US-China trade talks and encouraging January activity indicators suggesting continued strength in the US economy.

The S&P 500 Index and the Dow Jones Industrial Average Index delivered solid returns in February following on from a very strong January, ending the month up 3.2% and 4.0% respectively. The NASDAQ also returned a very credible +3.6%.

In January, the Fed signalled that it would pause raising interest rates. Data will need to be monitored closely as minutes released in February suggested that the Fed is still modestly biased towards tightening, despite the statement having conveyed a neutral bias. US activity indicators remain sound. Manufacturing ISM rose more than expected to 56.6 (previous: 54.9; consensus: 54.0) and non-farm payrolls beat expectations, rising 304K in January (previous: +222K; consensus: +165K).

Europe

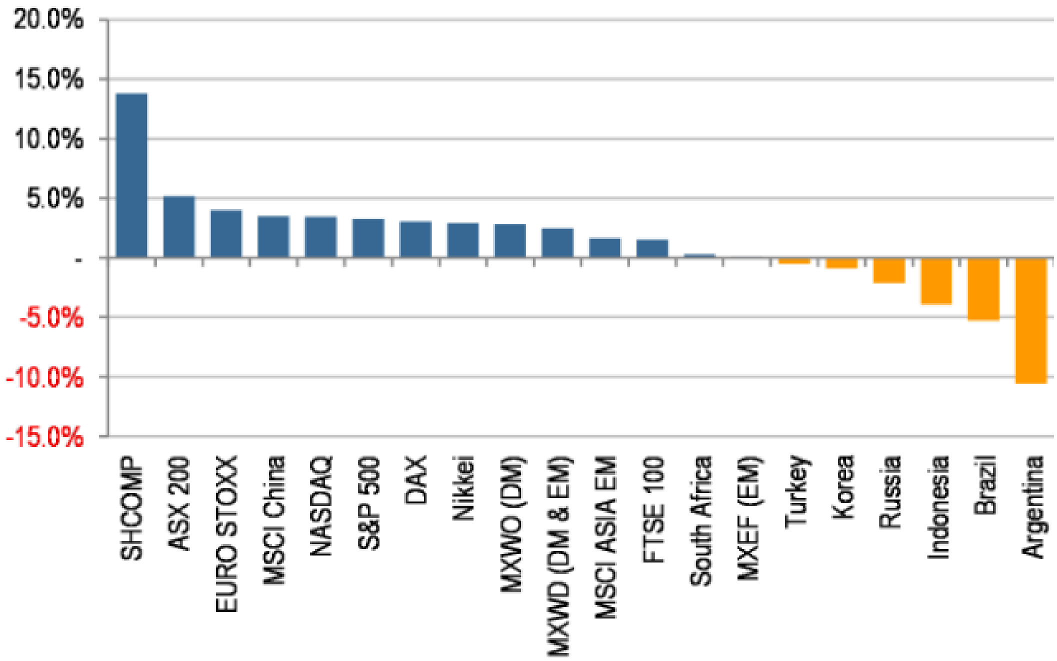
European equity markets also continued to deliver positive returns, with the Euro STOXX 50 Index up 4.4%. This was despite economic data continuing to moderate. The flash Eurozone manufacturing PMI for February disappointed with a reading of 49.2 (previous: 50.5; consensus: 50.3), but the composite PMI rose modestly to 51.4 (previous: 51.0). The major European indices were much stronger, catching the wave of optimism that a resolution between the US and China over trade would be positive for global growth: France's CAC was up an impressive 5.0%, Germany's DAX was up 3.1% and the FTSE 100 was up 2.3%.

Asia

Asian equities were mixed. The standout was the Chinese market, represented by the SSE Total Market Index, up a staggering 14.3%, as optimism on US-China trade talks firmed. The Hang Seng Index posted a more modest 2.7%, but Korea's KOPSI Composite Index delivered a disappointing -0.4%.

Questions still remain over the health of the Chinese economy. The February manufacturing PMI softened to 49.2 (previous: 49.5; consensus: 49.6) and the composite PMI also fell to 52.4 (previous: 53.2). Resolution and clarity on trade talks should provide some relief to a softening Chinese economy, which remains an area of concern and focus for markets, especially given the very strong rally in Chinese equity markets in February.

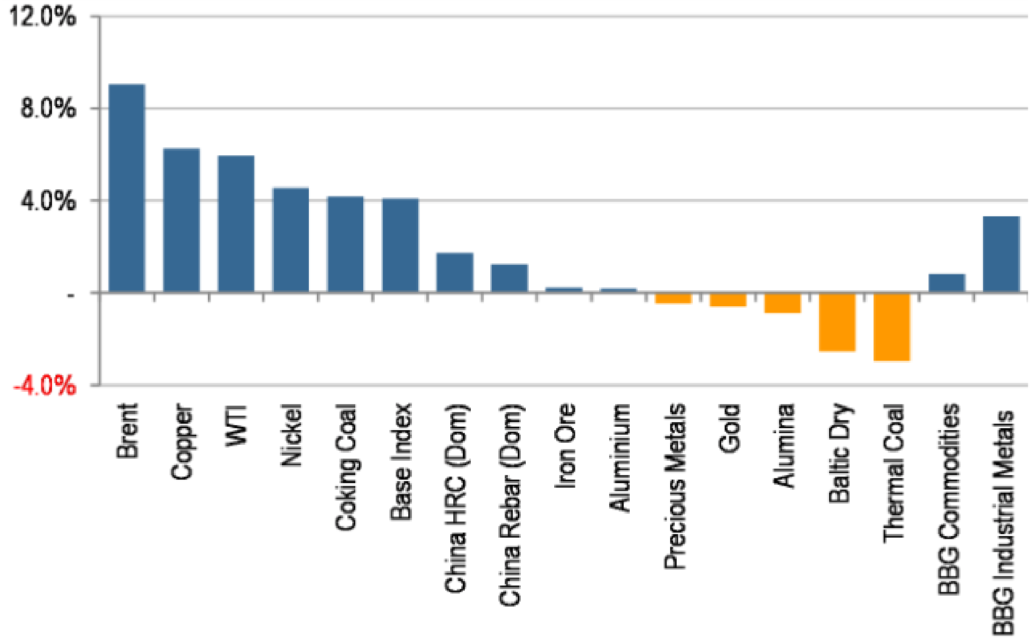
Global Equity Markets' Performance in February 2019



Source: JP Morgan, Bloomberg.

Commodities

The BBG commodities Index rose 0.8% in February. The best performer was Brent, which gained 9.1% to US$66.03 a barrel on falling US inventories, while the worst performer was Thermal Coal, which fell 3.0%. Gold prices fell on the back of a stronger US dollar.



Source: JP Morgan, Bloomberg.

Bonds

Global bonds sold off modestly in February on expectations of a rise in inflation from higher oil prices. US 10-year bond yields rose 8 basis points to close the month at 2.71%. The Australian 10-year bond yield fell again to close the month at 2.10% from 2.24% the previous month.

Australia

Australian shares performed best in the Developed Market. The **S&P/ASX 200 Accumulation Index ended the month up 6.0%.** With the exception of the Consumer Staples sector, all sectors delivered positive returns. The best three performing sectors were Financials (+9.1%), Energy (+7.9%) and Information Technology (+7.6%). The bottom three sectors were Consumer Staples (-1.5%, featuring for the second month in a row in the bottom three), Health Care (+1.0%) and Real Estate (+2.1%).

In February, the **ASX 200 Resources Accumulation Index was once again the best performer**, up 6.9% with BHP Group (+6.9%) and Rio Tinto (+10.5%) building on their strong performances in January as the market rewarded announced capital management initiatives. Woodside Petroleum (+9.4%) was also a significant contributor as investors cheered a better dividend and priced in a strong oil price. The Small Ordinaries Accumulation Index was only slightly behind with a strong return of +6.8% and the ASX 200 Industrial Accumulation Index was also impressive with a +5.8% return.

The top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were Coles (-8 points), Cochlear (-8 points), Stockland (-4 points), CSL (-4 points) and Saracen Mineral Holdings (-4 points).

The top five stocks that added to the index return were Commonwealth Bank of Australia (+68 points), Australia and New Zealand Banking Group (+55 points), Westpac Banking Corporation (+54 points), BHP (+46 points) and Macquarie Group (+25 points).

The pressure on house prices in Australia did not abate. National Corelogic dwelling prices fell 0.7% month-on-month in February, putting the year-on-year decline at -6.3% (the worst since March 2009). December residential building approvals fell, -8.4% which took the year-on-year decline to -22.5%.

Activity data was mixed: December retail sales fell more than expected at -0.4% (previous: +0.5%; consensus: +0.0%) but employment in January rose a greater than expected 39K (previous: +17K), with unemployment levels held steady at 5.0%. NAB's business conditions bounced to +7 in January from +3 previously and business confidence rose too.

In a surprise move, the RBA moved to a neutral bias and downgraded its GDP growth forecast modestly. The Australian dollar depreciated 2.4% against the US dollar to close the month at $0.7094. In trade-weighted terms, the AUD depreciated 1.5%.

CONTRIBUTION

Relative Value Gross Contribution -1.21%

Positive		Negative	
ELDERS - RURALCO HOLDINGS LTD	0.63%	CHARTER HALL GROUP - PEET	-0.41%
AGL ENERGY LTD - INFIGEN ENERGY	0.32%	DEXUS PROPERTY GROUP - PEET	-0.38%
CENTURIA CAPITAL - NATIONAL STORAGE REIT	0.13%	RIO TINTO - RIO TINTO	-0.31%
ARDENT LEISURE GROUP - VILLAGE ROADSHOW	0.12%	BWP TRUST - PEET	-0.27%
ASX LTD - LINK ADMINISTRATION HOLDINGS	0.10%	CHARTER HALL RETAIL REIT - PEET	-0.21%

Special Situations Gross Contribution 0.59%

Positive		Negative	
MCMILLAN SHAKESPEARE LTD	0.60%	ECLIPX GROUP LTD	-0.43%
JOHNS LYNG GROUP LTD	0.44%	PRO-PAC PACKAGING LTD	-0.20%
SUPERLOOP LIMITED	0.20%	ELK PETROLEUM LTD	-0.19%
IMPEDIMED LTD	0.14%	S&P/ASX 200 INDEX PUT OPTIONS	-0.12%
HEALTHSCOPE LTD	0.07%	PARAGON CARE LTD	-0.07%

Source: Ellerston Capital Limited

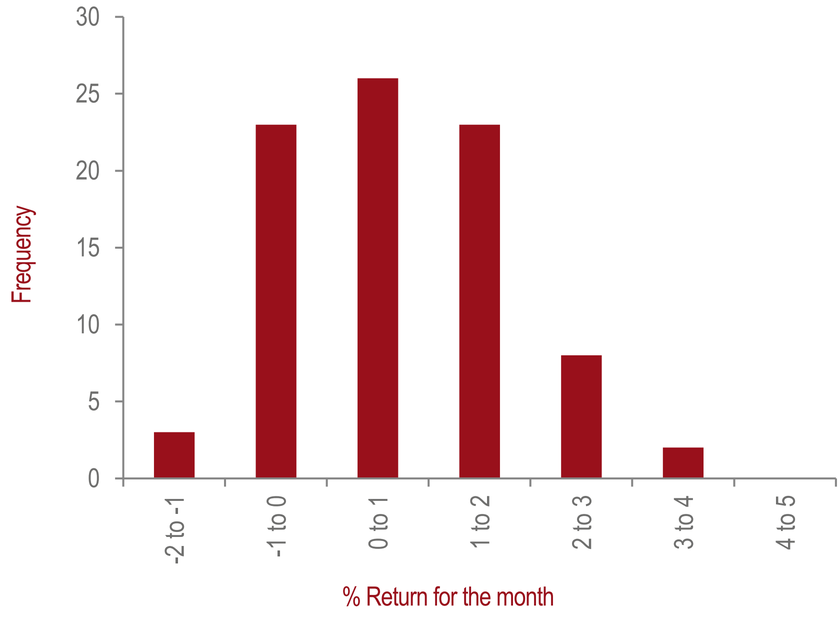
TOP 10 RELATIVE VALUE POSITIONS

- RIO TINTO - RIO TINTO
- BHP BILLITON - BHP BILLITON
- GROWTHPOINT PROPERTIES - INGENIA COMMUNITIES GROUP
- CENTURIA CAPITAL - DEXUS PROPERTY GROUP
- GPT GROUP - INGENIA COMMUNITIES GROUP
- CENTURIA CAPITAL - GPT GROUP
- CHARTER HALL RETAIL REIT - ELANOR RETAIL PROPERTY FUND
- CHARTER HALL GROUP - INGENIA COMMUNITIES GROUP
- AUSTRALIAN UNITY INVESTMENT REAL ESTATE - NATIONAL STORAGE REIT
- DEXUS PROPERTY GROUP - PEET

TOP 10 SPECIAL SITUATION POSITIONS

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

DISTRIBUTION OF NET RETURNS



Source: Ellerston Capital Limited

Key Service Providers

Registry: Link Market Services Limited

Auditor: Ernst & Young

Prime Broker & Derivative Counterparty:

Morgan Stanley Intl & Co PLC

Goldman Sachs International

Administrator: State Street Australia Limited

Material Matters

During the month there were no material changes to the Fund in terms of its risk profile, investment strategy or changes to investment staff which would impact this strategy. There have been no changes to the key service providers described above.

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