Ellerston Capital

Ellerston Australian Share Fund (ASF)

Performance Report | January 19

PERFORMANCE SUMMARY

Gross %	1 Month	3 Months	1 Yr	3 Yr p.a.	5 Yr p.a.	Strategy Since Inception p.a.
ASF	4.62	-1.58	-4.95	11.02	7.18	9.84
Benchmark	3.87	1.45	1.37	10.10	7.10	9.63

Past performance is not a reliable indicator of future performance.

MARKET COMMENTARY

Market Overview

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

USA

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

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

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

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

Europe

European equity markets were also much stronger in January, catching some of the improving global sentiment. The Euro STOXX 50 Index rose 5.5%, as economic data continued to soften, with Europe caught in the crossfire of the trade war that has led to a fall in demand from China. Manufacturing PMI fell to 50.5 (previous: 51.4) and the new export orders component of the PMI for the Eurozone remained below 50. Composite PMI also fell to 50.7 (previous: 51.4). In France, the flash PMI fell further as the "yellow vest" protests continue to impact the

Investment Objective

The Investment objective for the Ellerston Australian Share Fund 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 stocks in order to capture the neglected opportunities created by under-researched stocks in the broader Australian market.

Key Information

Strategy Inception Date	1 April 2009
Fund Net Asset Value	$0.9429
Liquidity	Daily
Application Price	$0.9453
Redemption Price	$0.9405
No Stocks	18
Management Fee	0.90%
Buy/Sell Spread	0.25%
Performance Fee	15%
Firm AUM	Over $5 Billion

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.

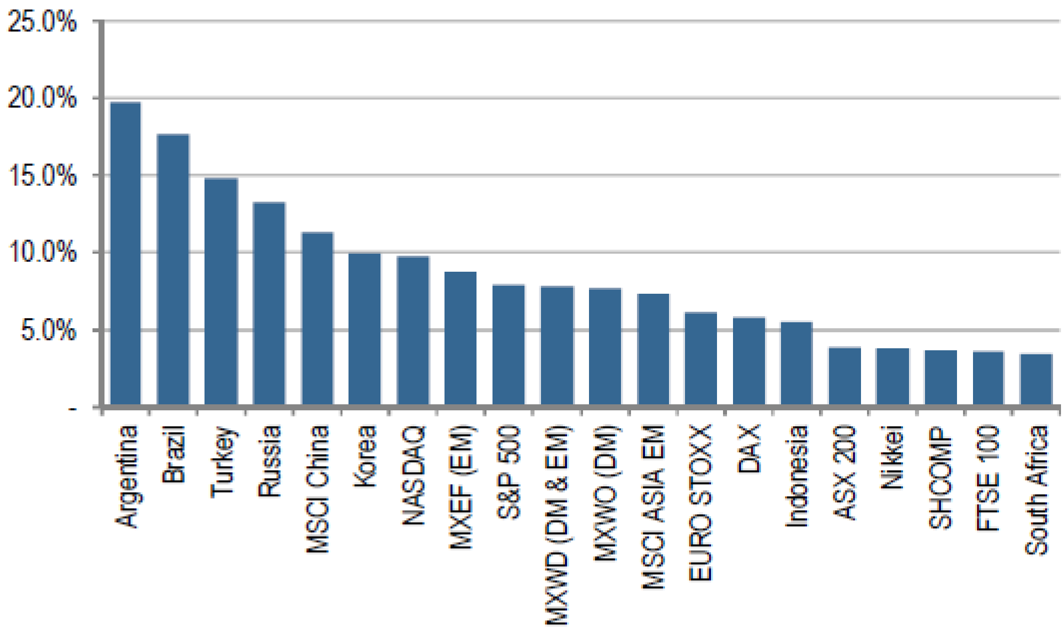
The market however looked through the data with all major European indices in the black. The UK's FTSE 100 was up 3.6%, France's CAC 40 was up 5.6% and Germany's DAX rose 5.8%.

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 (see separate write up).

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

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

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

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

COMPANY SPECIFIC NEWS

The Market Misses

Costa Group Holdings (CGC -25.5%)
CGC issued a nasty downgrade with the company now expecting flat NPAT in FY19, down from the previous guidance of low double digit growth. Astonishingly, the company had issued a positive update at its AGM on 22 November. Management blamed subdued demand in a number of categories, primarily tomato, berry and avocados during December 2018, with January trading conditions also appearing to be much weaker than expected.

Challenger (CGF -23.7%)
CGF downgraded its FY19 normalised earnings blaming weaker investment markets (understandable) and lower cash distributions from its absolute return portfolio (unexpected). New CEO Richard Howes was potentially 'kitchen sinking' earnings. The earnings downgrade followed the government delaying a key plank of long-term growth and doubts have started to emerge that the group's pre-tax ROE target of 18% may be too high. The market has taken flight and has significantly de-rated the company.

Resmed Inc (RMD -17.9%)
RMD's share price performance in January was a reminder of what happens when a market darling, trading on a lofty PE, delivers a disappointing earnings result with multiple issues. Firstly, revenue growth in the December quarter missed expectations, with device sales in France and Japan slowing dramatically as the benefits of reimbursement changes passed. Secondly, RMD has been buying software service providers, at the periphery of its core sleep apnoea business, where growth unexpectedly slowed. Rounding out the trifecta of bad news, management increased guidance for costs associated with R&D, sales staff and interest expense. The de-rating in the share price of this well-held name was vicious.

Elders (ELD -11.3%)
ELD shares declined on limited company news, however drought conditions in Australia continue to linger, impacting sentiment across the agricultural space.

Australian Pharmaceutical Industries (API -8.7%)
Difficult trading conditions in the pharmacy sector forced API to issue earnings guidance approximately 5% below market expectations. Downward pressure on prices for prescription medicines and weak retail spending over Christmas, were the key causes of the sales weakness.

Eclipx Group - (ECX -8.2%)
McMillan Shakespeare postponed the timeline of its merger with ECX after the latter downgraded guidance for FY19. With the stock trading approximately 15% below the implied bid price, the market is concerned that deal will not go ahead in its current form.

Galaxy Resources Ltd (GXY -7.8%)
GXY had a disappointing month following the release of its quarterly report which revealed cash margins fell to US$288/dmt, down 30% on the September quarter. Management blamed increased unit costs on higher strip ratios and overall weakness in pricing. Unfortunately for the sector, margin weakness appears to be an industry wide issue, with Orocobre also noting a significantly reduced margin over the December quarter.

The Market Hits

Fortescue Metals Group (FMG +34.8%)
Iron ore markets were thrown into disarray after another mining dam disaster shocked Brazil and the world's largest seaborne iron ore producer, Vale. In response to the January 26 tragedy, Vale announced it was suspending operations at 19 tailing dams, resulting in production losses of 40mta of high grade iron ore and 11mta of iron ore pellets. This lit a fire under iron ore prices, taking FMG's share price with it.

Beach Energy Ltd (BPT +33.8%)
BPT benefitted from a resurgent oil price during January on the back of OPEC production cuts and the prospect of a trade war resolution. In addition, BPT announced a strong quarterly in December, posting a +6% increase in oil output, strong drilling results from the Cooper Basin and a 30% increase in Otway gas sales.

Healius (HLS +30.5%)
During the month, the pathology and medical centre operator formerly known as Primary Healthcare, received a takeover bid from its largest shareholder, the China-based Jangho. There are serious doubts surrounding whether Jangho could get approval from the Foreign Investment Review Board given the sensitivity associated with a Chinese company controlling health records for millions of Australians. Consequently, the share price is trading at a circa 10% discount to the $3.25 bid price with the Board rejecting the highly conditional approach.

Afterpay Touch Group/ Appen (APT +28.3%/ APX +24.4%)
In what was a strong month for the tech sector broadly, both Afterpay and Appen stood out from the pack. A positive update from APT was the catalyst for the rally. During 1H19, APT's sales more than doubled to $2.2 billion and 7,500 new customers were joining the platform every day. News for APX was relatively light, but an upgrade to 'Buy' at investment bank UBS was enough to build momentum.

WorleyParsons (WOR +21.5%)
WOR rallied strongly during the month, benefitting from the renewed strength in oil.

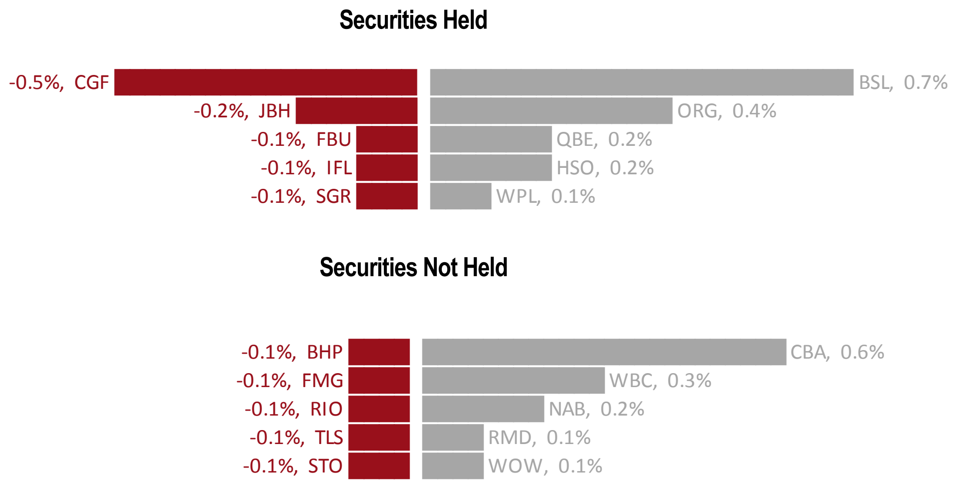
Magellan Financial Group (MFG +21.2%)
In an update in January, MFG announced yet another increase in FUM driven by an increase in net flows, despite weaker global equity markets. Performance was strong and the group announced a significant increase in performance fees for 1H19. This drove material increases to earnings forecasts and the stock was marked higher.

FUND PERFORMANCE

The month of January saw a much needed relief rally following a challenging 2018 year end. Pleasingly, your Fund captured the upside and delivered a positive return of 4.62%, outperforming the benchmark return of 3.87% over the period.

RETURNS[1] (%)	GROSS	BENCHMARK*	EXCESS	NET
1 MONTH	4.62	3.87	0.75	4.52
3 MONTHS	-1.58	1.45	-3.03	-1.86
ROLLING 12 MONTHS	-4.95	1.37	-6.32	-5.92
3 YEARS (P.A.)	11.02	10.10	0.92	9.86
5 YEARS (P.A.)	7.18	7.10	0.08	6.05
SINCE INCEPTION (P.A.)	9.84	9.63	0.21	8.66
SINCE INCEPTION (CUM)	151.57	147.00	4.57	126.35

Past performance is not a reliable indicator of future performance.



[1] The return figures are calculated using the redemption price for Class A Units and on the basis that distributions are reinvested. The Gross and Excess return figures are before fees and expenses whereas the Net Return figures are net of fees and expenses for the Class A Units. Returns of the Fund may include audited and un-audited results. Past performance is not a reliable indicator of future performance.
* The benchmark was changed from the S&P/ASX 200 Accumulation Ex REITS Index to the S&P/ASX 200 Accumulation Index on 1 July 2012.

The main contributors to this month's performance were overweight positions in core holdings, including BlueScope (BSL +13.6%), Origin Energy (ORG +10.7%), QBE Insurance (QBE +6.2%), and Healthscope (HSO +5.8%).

Having zero holdings in Commonwealth Bank (CBA -3.4%), Westpac (WBC -2.0%), NAB (NAB -0.9%), Resmed Inc. (-17.9) and Woolworths (WOW -0.2%) also had a positive contribution to performance.

The main detractors from performance were overweight positions in Challenger (CGF -23.7%), JB Hi-Fi (JBH +1.0%), Fletcher Building (FBU +1.9%) and Star Entertainment (SGR -2.6%).

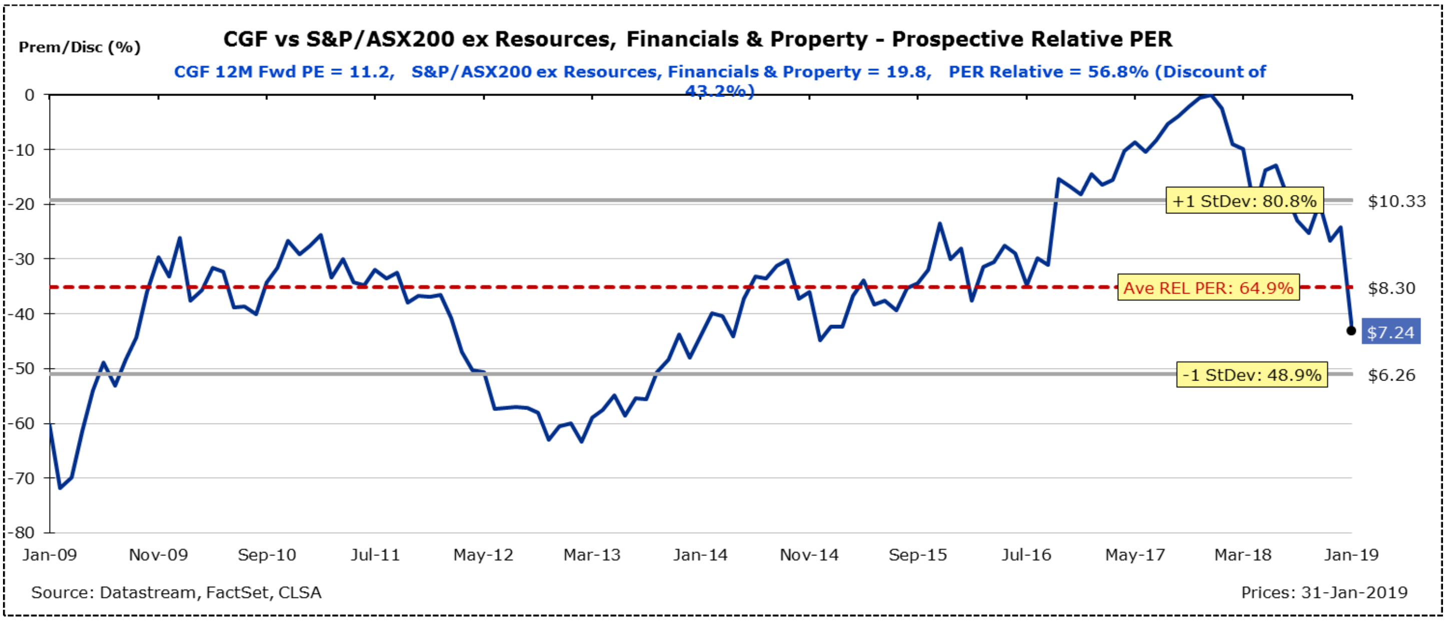
Having a zero holding in BHP Billiton (BHP +6.2%), Fortescue Metals (FMG +34.8%), Rio Tinto (RIO +10.9%), Telstra (TLS +9.1%) and Santos (STO +18.1%) also acted as a drag on the portfolios relative performance.

Challenger Limited

Challenger Limited (CGF) issued a profit warning in January and downgraded its FY19 normalised earnings, blaming weaker investment markets (understandable) and lower cash distributions from its absolute return portfolio (unexpected).

While some of the downgrade is understandable with respect to first half earnings given weaker investment markets toward the end of 2018, the downgrading of full year 2019 guidance was unexpected. It is possible that part of the downgrade to full year earnings could be explained by a new CEO (who commenced in January 2019) 'kitchen sinking' earnings and taking a more conservative view on investment market returns for the full year. But this has led to the market asking questions on the underlying investment return assumptions that CGF makes when providing its normalised earnings forecasts. The lingering issue for the market is whether the new CEO will step back from the group's pre-tax ROE target of 18%. CGF has already said that it does not expect to meet that return in FY19. The market now doubts the delivery of that ROE target even in the medium-term.

January's downgrade along with the government delaying a plank of long-term growth have seen earnings cut and investors de-rate the company significantly (see chart below). Following the de-rating, the stock appears cheap on just over 11 times one-year forward PE ratio and a dividend yield close to 5%, based on consensus earnings. Also, its second largest shareholder and strategic partner, the Japanese firm MS&AD Insurance Group, has been buying shares on market, which could provide some share price support.



Fund Activity

The Fund has again been highly active during January. We used the rally to trim some positions and at the same time have selectively strengthened stock positions, especially those stocks introduced more recently into the portfolio.

NEW STOCKS ADDED	STOCKS EXITED
• None	• None

POSITIONS INCREASED	POSITIONS DECREASED
• Aristocrat Leisure	• QBE Insurance Group
• BlueScope Steel	• Treasury Wine Estates
• Downer EDI	• Nufarm

Post their recent rebounds, we trimmed the portfolio's significantly overweight positions in QBE Insurance, Treasure Wine Estates and Nufarm. While we still like the fundamentals of these stocks, we felt it was prudent to reduce portfolio risk and take some profits going into results season.

Aristocrat Leisure and Downer EDI were introduced to the portfolio recently. We added to our existing positions in order to achieve a more meaningful weighting in these holdings. Bluescope Steel was oversold in the period and we used the sell-off to add modestly to our position.

FUND STRATEGY AND OUTLOOK

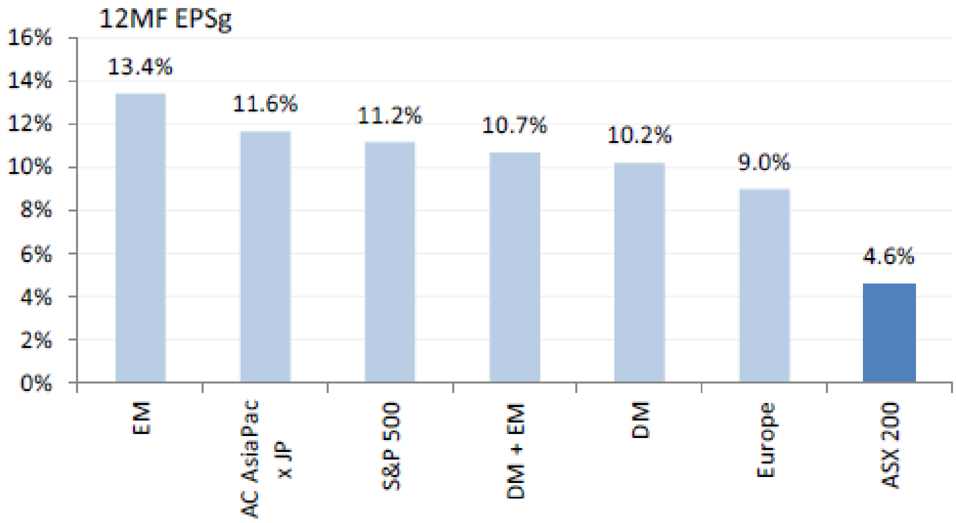
Last month, we articulated the concerns investors had over the potential for a monetary policy mis-step by the Fed. So unsurprisingly, the Fed turning dovish with its rate guidance in January had markets cheering. This has eased market fears in the short-term that the Fed was tightening rates too aggressively as the pace of global growth was slowing. It's unclear if the Fed will maintain its neutral stance if inflation and wage data in the US are stronger than anticipated, as the US payroll data trends remain very solid. Additionally, the harsh rhetoric from the US administration with respect to US-China trade talks has softened somewhat. A positive outcome from the talks would be welcome relief to the markets, as the trade war has hurt China, Europe and now seems to be biting in the US. That said, investors remain nervous with macroeconomic data pointing to weakening global growth and political uncertainty around the world continuing to act as likely headwinds.

We'd like to recapitulate the risks to investment markets we've previously identified. These include the negative effects of a trade war, slowing global growth (especially in China, where there are increasing concerns that the slowdown in their economy might be worse than initially feared) and the uncertainty and incoherence emanating from Trump's White House - a risk factor that the market is only now seemingly fully coming to grips with. Domestically, the risks include the second-order effects of the macro drivers above, along with sharply slowing credit growth, an indebted consumer, fear of a harder economic landing and a pending Federal election this year.

It makes for a very volatile investment environment in 2019. The correction in many stock prices presented us with plenty of fresh opportunities that we took advantage of selectively. On the positive side, we would expect more capital management initiatives as surplus franking credits are cleared and the prospect of more M&A activity if the AUD weakens further.

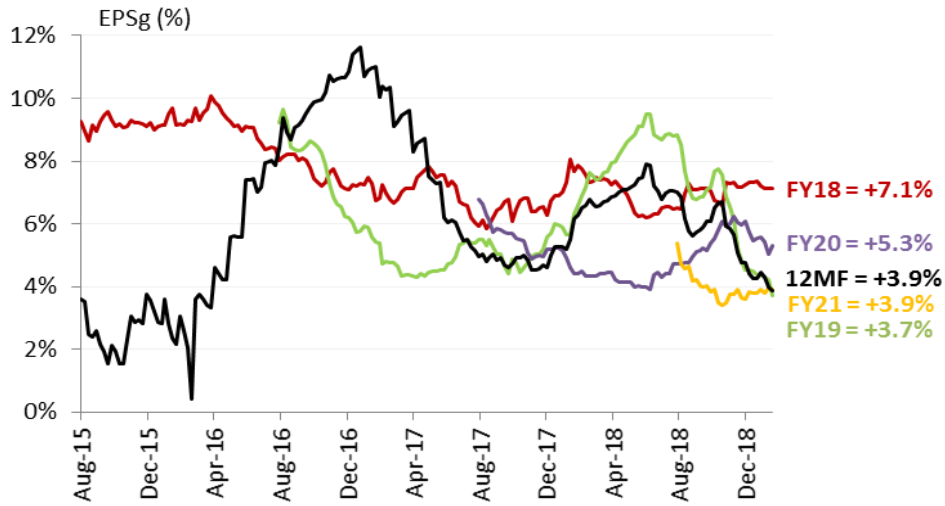
Following the rally in January, the ASX 200 Index is now trading at a PE multiple of 14.7 times, well below the peak reached in August 2018 of 15.9 times. Even the Industrials ex-Financials have de-rated from a peak multiple of 22.2 times to now around 20 times. The upcoming reporting season will be critical for earnings forecasts to support the market. The chart below shows that earnings growth for the Australian market does not look particularly attractive in an international context.

12-month forward EPS growth for Australian equities relative to global markets



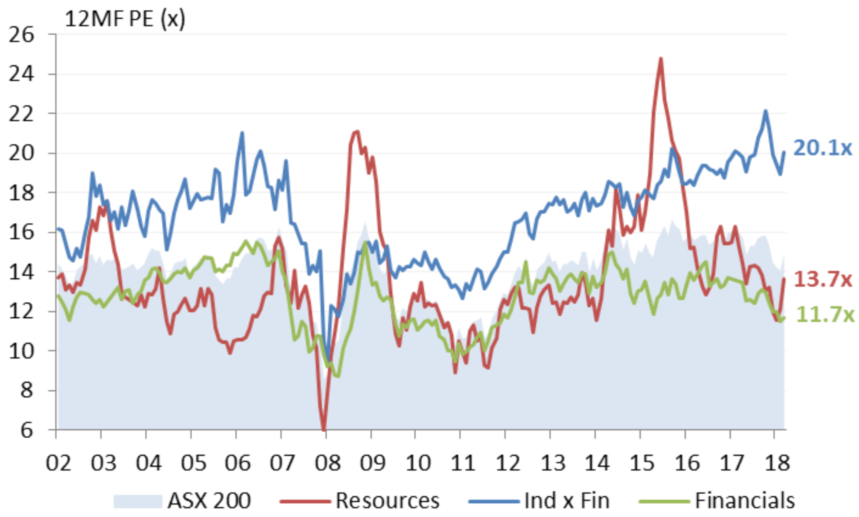
Source: RIMES, IBES, Morgan Stanley Research

The chart below shows that earnings expectations domestically have been marked back to mid-single digits, with FY19 now at just 3.7% growth.



Source: RIMES, Morgan Stanley Research.

Following the rally in the Australian market in January, the Industrials ex-financials valuations are ticking up towards previous highs, making the results season critical to justify ratings.



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 which are mispriced based on longer term prospects.

  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, Woodside Petroleum and Origin Energy

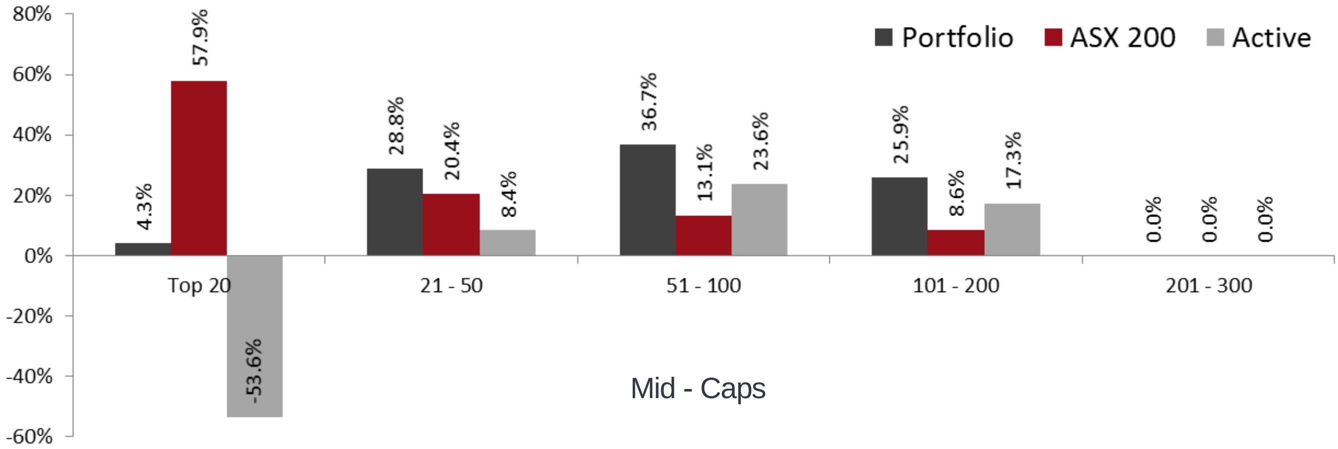
- Still **Zero Banks** (a position held for some years now), despite their underperformance versus the broader market for the past three years. We believe better opportunities exist in other segments of the market offering superior earnings growth.

Warm Regards,

Chris Kourtis
Portfolio Manager

PORTFOLIO FEATURES

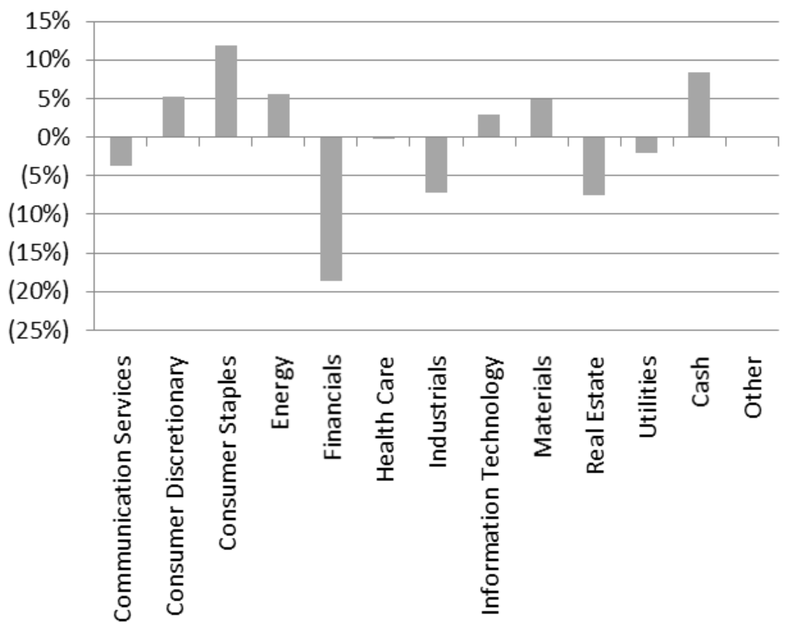
Size comparison Chart vs ASX 200^



^Size Comparison Data as at 29 January 2019

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

* 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 AUSTRALIAN SHARE FUND

The Fund aims to achieve its performance objectives by adopting a fundamental "bottom-up" investment approach to stock selection which is focused on identifying and then constructing a portfolio of the highest conviction ideas.

Investment opportunities for the Fund are identified by analysing and understanding the factors affecting (amongst other things): business model, industry structure, management team and overall valuation. Ellerston Capital typically favours businesses that can sustain high returns or improve their return on capital and looks to invest in businesses with a market value below the value we attribute to them.

Benchmark weightings do not drive our stock decisions, our approach is totally benchmark independent.

Due to the high conviction nature of the portfolio and the resulting deviation in portfolio composition relative to benchmark weighting, it is expected that the returns from the Fund will differ significantly from the broader market indices.

FUND FACTS

STRATEGY FUNDS UNDER MANAGEMENT	$3.2 BILLION
FUNDS UNDER MANAGEMENT – ASF UNIT TRUST	$52 MILLION
APPLICATION PRICE	$0.9453
REDEMPTION PRICE	$0.9405
NUMBER OF STOCKS	18
INCEPTION DATE	1 APRIL 2009

Source: Ellerston Capital Limited

For further information, please contact:

INSTITUTIONAL CONTACT

Melinda Carter
+61 3 9002 2041
mcarter@ellerstoncapital.com

RETAIL CONTACT

Andrew Seddon
+61 417 249 577
aseddon@ellerstoncapital.com

Simon Glazier
+61 2 9021 7790
sglazier@ellerstoncapital.com

SYDNEY OFFICE

Level 11, 179 Elizabeth Street,
Sydney NSW 2000

MELBOURNE OFFICE

Level 4, 75-77 Flinders Lane,
Melbourne VIC 3000

Ph: +61 2 9021 7797
E: info@ellerstoncapital.com