ELLERSTON CAPITAL

Ellerston Australian Share Fund (ASF)

Performance Report | August 19

PERFORMANCE SUMMARY

Net %	1 Month	3 Months	FYTD	1 Yr	3 Yr p.a.	5 Yr p.a.	Strategy Since Inception p.a.
ASF	-3.00	3.84	3.20	-6.42	4.09	4.91	8.47
Benchmark	-2.36	4.23	0.52	9.04	11.38	7.90	10.62

Past performance is not a reliable indicator of future performance.

MARKET COMMENTARY

Market Overview

Global equity markets were unsettled by renewed tensions over trade between the US and China and fears over slowing global growth. Equities delivered negative returns overall, but most of the pain was felt in Emerging Markets, down 5.1%. A surging US dollar and the collapse of Argentina's equity market (-51%) following the shock defeat of that country's President in their elections, sparked fears of contagion, weighing heavily on Emerging Markets. Developed Markets fell 2.2%, impacted by weakness in technology shares and the sharp fall in the FTSE 100 on "no deal" Brexit fears.

USA

The S&P 500 Index and the Dow Jones Industrial Average Index were in negative territory in August, returning -1.6% and -1.3% respectively. The NASDAQ was also weaker, with a return of -2.5% as tech stocks were caught up in trade war concerns. President Trump escalated all-out trade war fears by announcing a 10% tariff on the remaining $300 billion of Chinese exports to take effect on 1 September. But the US then delayed some tariffs until 15 December, seemingly to allow for Christmas purchases by US consumers. China retaliated with plans to impose tariffs on $75 billion of US goods. The trade war ping-pong has resumed. In the meantime, the Fed kept rates on hold, July ISM Manufacturing came in below expectations at 51.2 and US 2Q GDP came in flat for the June Quarter at 2%.

Europe

European equities were weaker across the board, with the Euro Stoxx returning -1.1%. Brexit, global trade fears and slowing growth pressured markets.

The UK's FTSE 100 was the worst performer falling 4.1%, as a "no deal" Brexit looked increasingly likely after new PM Johnson's strong push towards a hard Brexit. France's CAC 40 returned -0.7% and Germany's DAX returned -2.1%, impacted by weak economic data confirming that the German economy was slowing, with the Banks and Insurance sectors weighing on the market.

Asia

Asian equities finished the month in the red, as the trade war rhetoric heated up, the USD strengthened and ongoing protests in Hong Kong which showed no signs of de-escalation, depressed investors' appetites.

Japan's Nikkei 225 was a poor performer with a return of -3.7%, but Hong Kong's Hang Seng (-7.1%) was the worst performer in the region, as civil unrest continued unabated. Other markets suffered, as the US and China traded blows on tariffs, with Korea's KOPSI Composite Index finishing down almost 3%, and the Chinese SEE Total Market Index recording a 1.1% decline, not helped by the Industrial Production print which surprised to the downside by falling to 4.8% vs 6% expected in July.

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	$0.9168
Liquidity	Daily
Application Price	$0.9191
Redemption Price	$0.9145
No Stocks	20
Management Fee	0.90%
Buy/Sell Spread	0.25%
Performance Fee	15%
Firm AUM	Over $5 Billion

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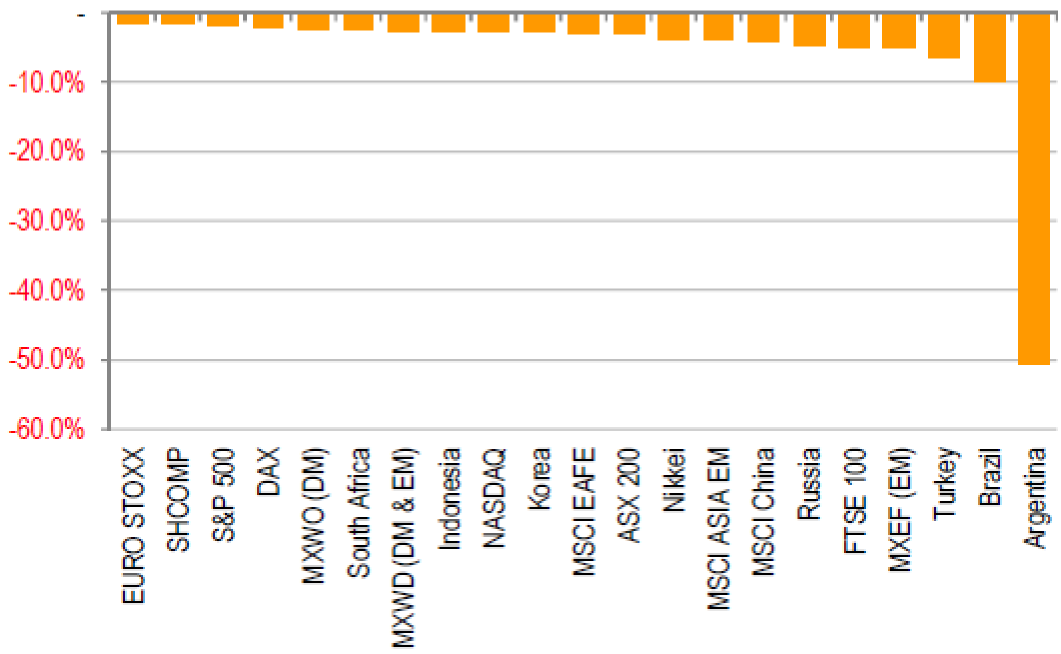
Global Equity Markets' Performance in the month of August 2019

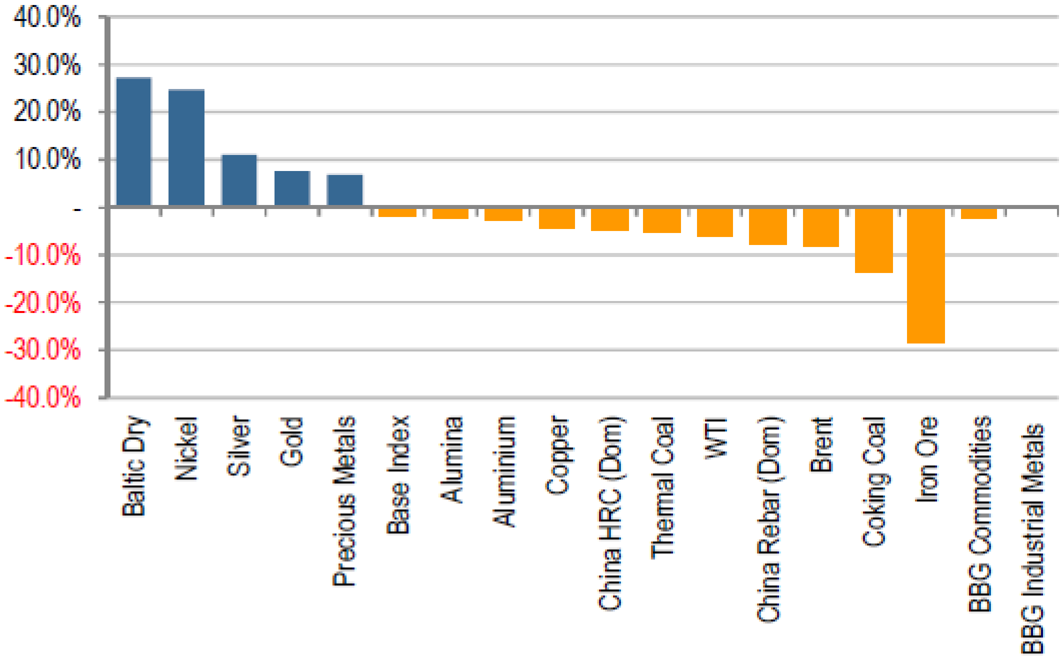


Source: JP Morgan, Bloomberg.

Commodities

The commodities index slipped again in August, impacted by concerns over slower growth and trade war tensions. Iron Ore prices which spiked to US$122/t only recently, tumbled spectacularly in August, falling 28.3% to US$84.80/t. This broke the eight consecutive month positive run! Other bulks were also in negative territory with Coking Coal dropping 13.8% and Thermal Coal down 5.3%. In base metals, Nickel was the standout outperformer (+24.6%) on supply side concerns, but unsurprisingly, Copper (-4.2%), Aluminium (-2.8%) and Alumina (-2.2%) were all weaker, closely tied to slowing global Industrial Production. Brent also was lower too and ended the month down 8.2% to $59.25/bbl. In August's risk-off environment, precious metals were stronger, with Gold and Silver gaining 7.5% and 10.9% respectively.

Commodity Performance in August 2019



Source: JP Morgan, Bloomberg.

Bonds

Continued worries over global growth saw bond yields drop even further in August. US 10-year bond yields closed the month at 1.5%, falling by over 50 basis points. The sharp fall in the long end of the US yield curve saw the curve invert once again, sparking fears of a pending recession down the track. The Australian 10-year bond yield fell to a new all-time low of 0.89% in August.

Australia

The S&P/ASX 200 Accumulation Index ended the month down 2.4%, breaking its run of 7 consecutive months of gains, with the results season delivering weak aggregate EPS growth and subdued outlooks. The index is however, still +20.3% for the calendar year to date.

In August, the best three performing sectors in terms of their contribution to the index's performance were Health Care (+3.6%), Real Estate (+2.3%) and Consumer Discretionary (+0.2%). The bottom three sectors were Materials (-7.3%), Financials (-2.6%) and Energy (-5.6%).

The ASX 200 Industrials Accumulation Index was the best performer with a return of -1.0%. The Small Ordinaries Accumulation Index returned -3.9%, while the ASX 200 Resources Accumulation Index fell 7.5%. The top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were BHP Group (-74 points), Australia and New Zealand Banking Group (-19 points), National Australia Bank (-18 points), Rio Tinto (-17 points) and Brambles (-17 points). The worst performing stock in the Index was Speedcast International which fell 58.9% in the month, after reporting that its 1H19 NPAT had fallen 30%.

The top five stocks that added to the positive index return were CSL (+30 points) taking the top spot for the second month in a row, Woolworths Group (+17 points), Lend Lease Group (+10 points), Newcrest Mining (+7 points) and James Hardie Industries (+7 points).

After two rate cuts in as many months and the expected lag in economic activity, the RBA left the cash rate on hold, with minutes suggesting that it was likely to keep rates steady for a period. The RBA was looking for domestic activity to deteriorate materially before more rate cuts would be forthcoming. The NAB business survey in July was disappointing – confidence improved from +2 to +4 but conditions eased to +2 from +4, and employment intentions were well down. Conditions in the retail sector were tough, with weaker house prices and no real wage growth depressing the demand for goods.

The Australian dollar ended the month 1.6% lower against the US dollar at 0.67 cents.

COMPANY SPECIFIC NEWS

The Market Misses

Speedcast International (SDA -58.9%)

For the second month running Speedcast was the worst performer in the ASX200. Despite meeting downgraded guidance given in July, negative operating cashflow and departure of both the Chairman and CFO spooked the market. With net debt now more than double the market cap the company could stay in the wilderness for some time.

Ooh! Media (OML -30.5%)

This out-of-home advertising provider unexpectedly downgraded its earnings guidance for the 2019 calendar year by approximately 17%. A significant decline in advertising demand in the September quarter was the culprit (down 11-12% vs the same quarter last year), a function of management distraction with the integration of the Adshel acquisition, aggressive competition from at least one peer and overall weakness in the Australian advertising market. Forward bookings for the December look more promising, a comfort given high gearing levels.

Illuka Resources (ILU -25.7%)

The company posted a first half result that underwhelmed but it was the poor near term outlook that weighed on the share price. Demand for one of its key commodities, zircon, is weak and unlikely to improve in the short term.

Pilbara Minerals (PLS -25.5%)

More bad news for a company that finds itself on the 'misses' list for the third straight month! Lithium prices remain under pressure due to supply/demand imbalance and PLS has had to significantly cut its sales guidance for the September quarter. The company entered into a trading halt late in August, where it still remains, in the anticipation of a capital raising and is a strong candidate to make its 4th consecutive appearance in the 'misses'!

Bellamy's Australia (BAL -25.7%)

BAL's FY19 results missed expectations with NPAT of $30 million falling 15% below consensus. Moreover, despite an upbeat assessment of the future from management, FY20 revenue growth of 10-15% and EBITDA margins of 17.6% underwhelmed with consensus revenue growth expected to be 18% and margins north of 20%.

Corporate Travel Management (CTD -24.8%)

Corporate Travel Management reported above consensus full year results however outlook guidance was subdued by ongoing macro concerns including HK protests, Brexit and the US-China Trade war.

WorleyParsons - (WOR -23.0%)

WOR was impacted by several issues across August. As a bellwether for global macroeconomic sentiment the resurgent trade war fears hurt. Moreover, despite strong revenue growth delivered by the group in FY19, margins were lower on higher overheads.

Inghams Group - (ING -21.9%)

ING's profits in FY19 were marginally below expectations but its FY20 outlook missed significantly. Higher wheat costs, driven by drought conditions which are unlikely to abate any time soon, were the main driver of the downgrades.

a2Milk - (A2M -20.9%)

A2M delivered a strong result in FY19 with revenue up 41% and EBITDA 46%, albeit slightly below consensus. However it was softer guidance that impacted the stock with margins in FY20 expected to contract materially to ~28% as the company invests for the long-term. In addition, the company stepped away from its plans to breakeven in the US by FY22.

Boral - (BLD -15.0%)

BLD's share price was savaged after it issued profit guidance for FY20 that was approximately 18% below expectations. Softer Australian housing demand and a temporary delay in some major infrastructure projects were the key issues. The company also announced a deal to buy out Knauf from the Australian plasterboard JV and at the same time combine Knauf's Asian stand-alone assets into an even larger Asian plasterboard JV.

Brambles - (BXB -13.9%)

After a strong run in FY19, expectations built that BXB would begin to translate that enthusiasm into earnings momentum. That enthusiasm was dashed with the release of its FY20 outlook that suggested sales growth would be at the lower end of mid-single digits and profits, excluding the impact of AASB 16 changes, would be flat.

The Market Hits

Nanosonics (NAN +21.1%)

The profit result for this manufacturer of ultrasound probe disinfection technology was well received and the share price continued its march higher, more than doubling since January. The market is particularly excited about new distribution agreements covering several countries and the prospect that it's much hyped (but still mysterious) new product will be launched in the next 12 months.

SmartGroup (SIQ +21.0%)

Smart Group reported half yearly results, surprising the market with robust novated lease growth despite a weak new car sales environment.

Pro Medicus (PME +19.7%)

Another Australian software developer making it big on the world stage. It is seeing strong demand for its radiology software on the back of significant productivity improvements. Investors are clearly focussed on the rapid sales growth profile and, at least for now, do not seem to be too worried about valuation with the company trading on 60x FY20 revenue!

LendLease Group (LLC +19.4%)

LendLease reported numbers broadly in-line with market consensus but surprised positively on the sale process of its troubled Engineering and Services division. The company suggested that several parties were undertaking detailed due diligence of the assets and that the current provision of $450 - $550 million remained appropriate.

McMillian Shakespeare (MMS +17.9%)

During the month McMillan Shakespeare reported full yearly results, surprising the market with robust novated lease growth despite a weak new car sales environment and the announcement of an off-market buy back.

Credit Corp Group (CCP +16.0%)

CCP announced that it had acquired Baycorp Holdings for $65 million from Encore Capital Group. As a result, CCP upgraded its FY20 NPAT. The balance sheet provides management with further acquisition optionality. The market reacted positively to the earnings upgrades.

Afterpay Touch (APT +15.9%)

APT delivered strong top-line growth of 86% driven by the Australian operations. Whilst EBITDA missed consensus and analysts lowered mid-term forecasts, the focussed remained very much on the long-term including the build out the US and UK operations. FY22 guidance to achieve underlying sales of $22 billion (FY19 $5.2 billion) and net transaction margin of 2% were enough for the believers.

WiseTech Global (WTC +15.6%)

WTC's FY19 results were in-line with consensus with revenue of $348 million and EBITDA of $108 million. Revenue jumped 57% which was driven by both acquisitions and organic growth. FY20 guidance for revenue of $440-$460 million impressed investors.

Beach Energy (BPT +15.5%)

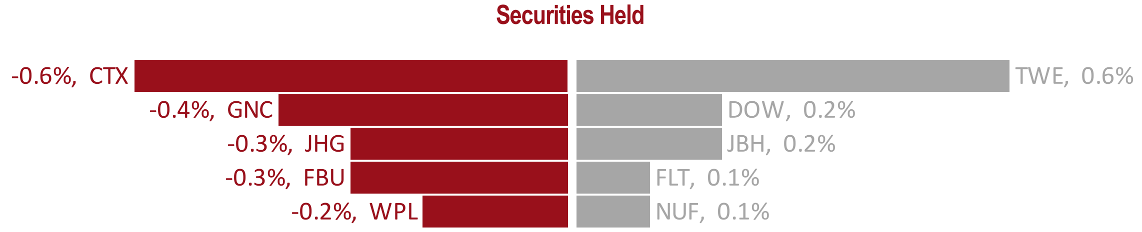
BPT had another strong month with its FY19 results coming in at the top end of guidance and the group delivering a positive outlook for FY20. The key to FY20 enthusiasm was BPT's plan to double drilling rates in the Cooper Western Flank which could deliver production growth of 30%.

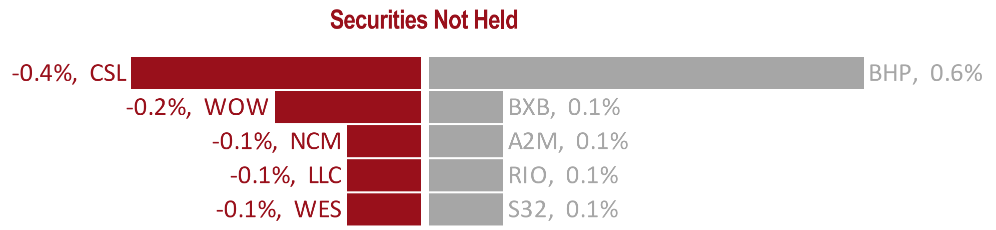
FUND PERFORMANCE

Following a very strong month in July, the Fund gave back some of the gains during a volatile reporting season where downgrades vastly outnumbered upgrades, slightly underperforming the market return of -2.36%. This result season will go down as one of the worst on record in terms of EPS revisions, where headline earnings revisions were very weak. The 1.9% decline in the ASX200 EPS estimate was the deepest result season scale-back since Feb-09. Moreover, with 113 downgrades, the proportion of stocks by number which saw downgrades was nearly 70% - the weakest "breadth" reading for well over five years.

RETURNS[1] (%)	GROSS	BENCHMARK*	EXCESS	NET
1 MONTH	-2.92	-2.36	-0.57	-3.00
3 MONTHS	4.12	4.23	-0.12	3.84
FYTD	3.38	0.52	2.86	3.20
ROLLING 12 MONTHS	-5.39	9.04	-14.43	-6.42
3 YEARS (P.A.)	5.20	11.38	-6.18	4.09
5 YEARS (P.A.)	6.04	7.90	-1.86	4.91
SINCE INCEPTION (P.A.)	9.64	10.62	-0.98	8.47

Past performance is not a reliable indicator of future performance.





Source: Ellerston Capital..

The main positive contributors to this month's performance were overweight positions in Treasury Wine Estates (TWE +5.9%), Downer EDI (DOW +6.8%), JB Hi-Fi (JBH +11.1%) and Flight Centre (FLT +0.9%).

Having zero holdings in the miners and other well held stocks were also a reasonable contributor to performance, with BHP Group (BHP -11.0%), Brambles (BXB -13.9%), A2 Milk (A2M -20.9%), Rio Tinto (RIO -8.4%) and South 32 (S32 +15.9%) all underperforming the market.

The main detractors were overweight positions in Caltex (CTX -11.1%), GrainCorp (GNC -6.9%), Janus Henderson Group (JHG -9.5%), Fletcher Building (FBU -9.0%) and Woodside Petroleum (WPL -5.8%).

Having a zero holding in CSL (CSL +4.9%), Woolworths (WOW +6.0%) Newcrest (NCM +4.6%), Lendlease (LLC +19.4%) and Wesfarmers (WES +1.8%) also constrained returns.

[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.

FUND ACTIVITY

In August the fund was highly active again. We introduced James Hardie Industries and increased Core positions (Aristocrat Leisure, Downer EDI and Flight Centre) and participated in the capital raising by Macquarie Group. We took further profits in JB Hi-Fi, QBE Insurance Group and Treasury Wine Estates given recent strength, and continued to reduce the Fund's position in Bluescope.

We have provided an update on James Hardie Industries and Macquarie Group. Also, we thought it was relevant to feature Treasury Wine Estates following its solid results update and in light of the ill-informed commentary in the run up to the results.

NEW STOCKS ADDED	STOCKS EXITED
• James Hardie Industries	

POSITIONS INCREASED	POSITIONS DECREASED
• Aristocrat Leisure	• Bluescope
• Caltex	• JB Hi-Fi
• Downer EDI	• QBE Insurance Group
• Flight Centre	• Treasury Wine Estates
• Macquarie Group	
• Orica	

James Hardie Industries (JHX)

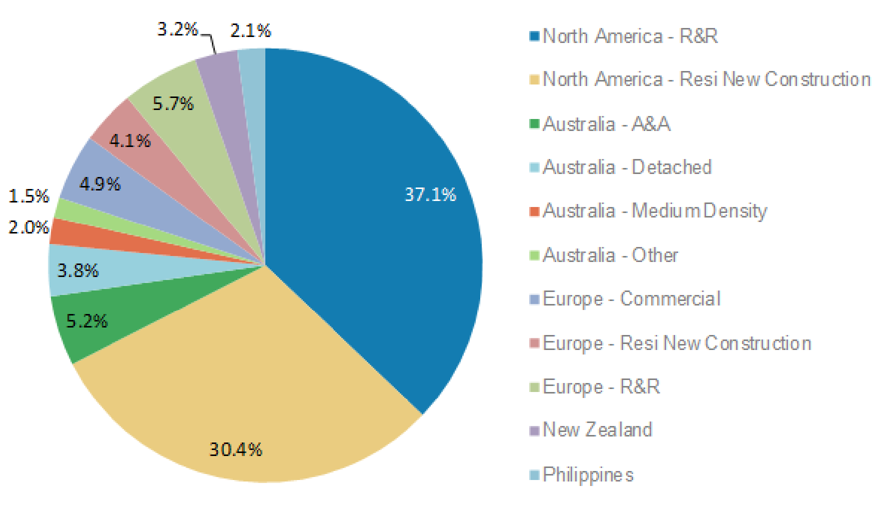
James Hardie Industries (JHX) was added to your portfolio ahead of its first quarter profit result, released on 9 August 2019. The buying was well timed. Flying in the face of soft peer group results, James Hardie delivered better than expected earnings, posting +5% growth in sales of home siding products, when many of its competitors were experiencing sales declines. The stock jumped 14% on the day of the results.

So why did we add James Hardie to the portfolio?

In the 12 months leading up to the first quarter result, James Hardie had underperformed the S&P/ASX 200 Index by ~25%. The market had been concerned about stalling US housing data and the CEO transition (risk of an earnings rebase). But all that worry created an opportunity to pick up a very attractively priced quality business with a strong franchise taking market share, emerging tailwinds, material self-help initiatives and an improving cash flow profile.

The US housing construction market remains the key driver of revenue and earnings for James Hardie.

James Hardie net sales exposure (US$m)

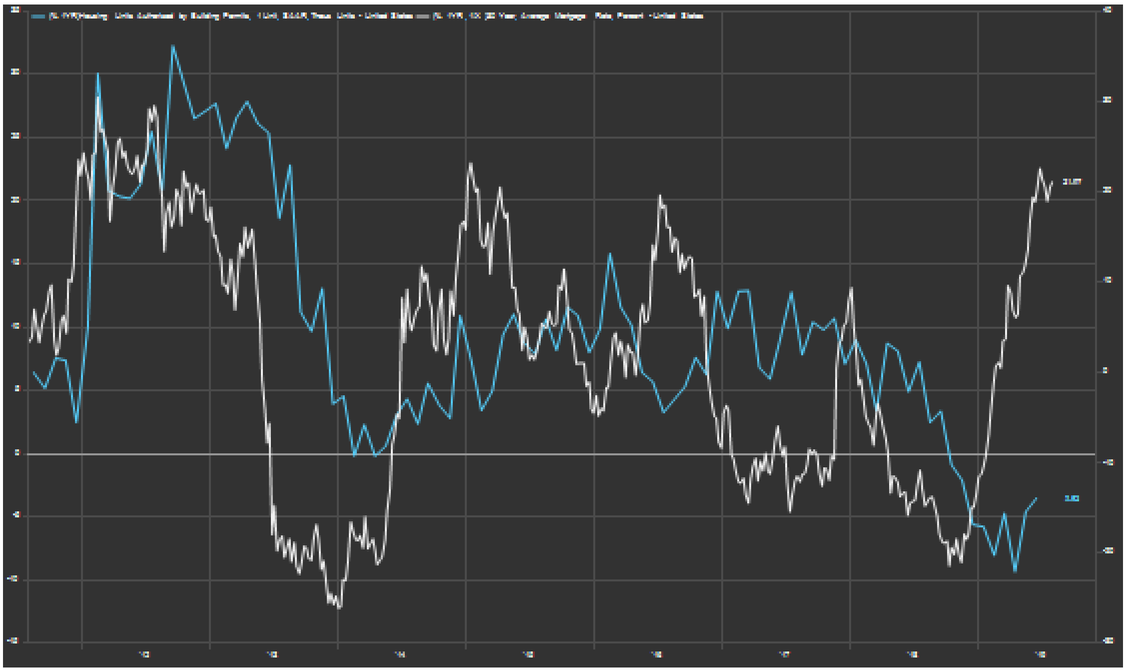


Source: Morgan Stanley, company reports

The risk to US housing starts could be skewed to the upside for the following reasons:

- There has been a rapid decline in US 30 year mortgage rates that cannot be ignored given the strong lead it normally provides to single family permits (chart below)
- Home builder sentiment is down sharply from the peak, but still at a level that implies growth in activity
- US home builders have recently been reporting solid forward order books
- US household leverage is well below similar countries such as Canada, Australia and the UK.

US single family permits growth (blue) follows the change in 30 year mortgage rates (inverted, white)



Source: Factset

The US Repair and Remodel (R&R) market is the largest component of revenue, but also one of the company's more stable revenue sources. Housing turnover, employment confidence and non-discretionary repairs are the key drivers of R&R demand. Leading indicators of R&R demand have softened (specifically, existing home sales) but remain at levels consistent with modest growth over the next 12 months.

Leading Indicator of Remodelling Activity – second quarter 2019

Source Joint Centre for Housing Studies of Harvard University

The third and one of the most important drivers of revenue growth in the US, in addition to new construction and R&R activity, is market share gain or what JHX likes to refer to as "primary demand growth" (PDG). PDG growth had been weak in recent periods, a function of:

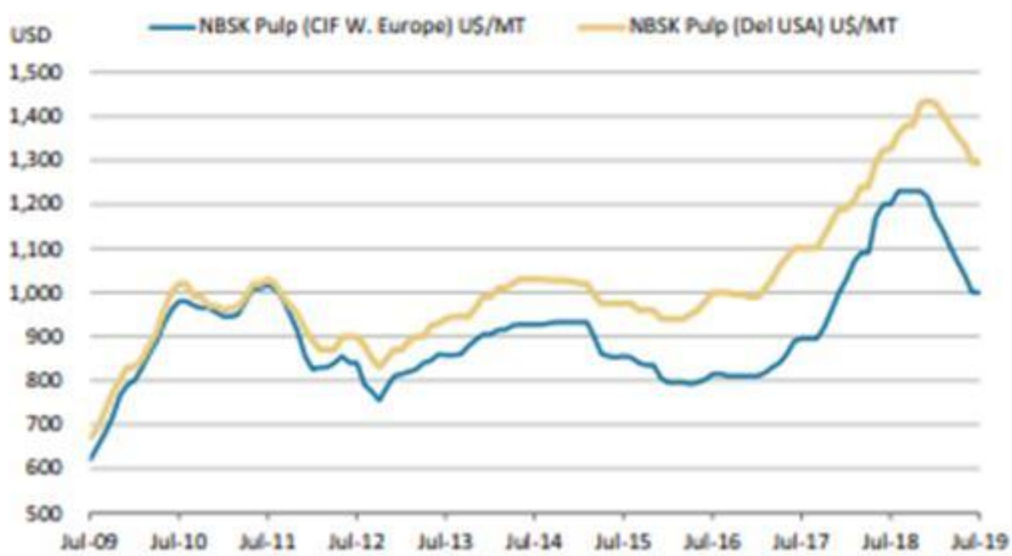
- Insufficient capacity in the right places to meet demand
- Operational missteps in manufacturing
- Better competition from Louisiana Pacific's (LP's) engineered wood alternative
- Affordability concerns that has seen new housing demand skew towards smaller, lower priced houses - not the JHX sweet spot.

But PDG reacceleration seen in the most recent quarterly result is likely to continue and be a key focus area to investors because:

- New home construction growth rates in the South and West regions (where fibre cement is much more prevalent) continue to exceed national averages, due to better land availability and relative affordability, especially vs the Northeast
- Production capacity constraints have been resolved with the ramp up of new capacity - James Hardie will have an effective surplus of more than 70% over existing demand by the middle of 2020
- A 'lean' manufacturing program put in place by the new CEO will extract $100m in annual cost savings, much of which will be reinvested into sales initiatives
- The sales organisational structure and staff incentives have been realigned for greater focus on retention, not just customer acquisition
- A rationalisation of ColorPlus options to reduce cost and improve on-the-wall price competitiveness against the LP and vinyl alternatives, especially in the Central/North East region of the US where pre-painted siding is of greatest value.

Raw material costs have also turned from headwind to tailwind, in particular pulp prices have fallen ~10% from the peak reached in the second half of CY18. There was no benefit in the strong margin result James Hardie posted for the first quarter but it will start to assist margins over coming quarters and make it easier for James Hardie to hit the top end of its 20-25% EBIT margin target range for FY20.

Pulp prices down significantly



Source: NBSK, Morgan Stanley

Europe, post the Fermacell acquisition, is still only 15% of Group revenue and less than 10% of group operational EBIT. But James Hardie plans to triple EU revenue over ten years (+8-12% CAGR) and increase the EBIT margin from ~10.6% to more than 14%. These projections are predicated on moderate growth in the core Fermacell business and leveraging acquired distribution relationships to sell more fibre cement products –this time, taking more appropriate product styles from the Australian operation where architectural tastes still differ to the EU but the products are more aligned with market demand than the US product portfolio it used to try to sell to EU customers.

We and the market are right to be sceptical about the EU ambitions and sell-side expectations for the EU are at or below the low end of the long-term management target range. For that reason it is not a material threat to near term earnings expectations.

Asia Pacific (predominantly Australia) is still ~18% of group earnings. Construction activity has clearly peaked with dwelling approvals down low double digits. But JHX has a good long term track record of steady earnings growth in Asia Pacific despite some periods of significant declines in construction activity (notably 2012/13, 2016/17). Modest market share gains and raw material cost tailwinds are likely to see earnings hold at high levels in the short term. Two interest rate cuts by the RBA may stabilise housing construction demand, albeit there is no sign of that occurring yet, apart from the improvement in auction clearance rates.

Cash flow is improving. Capex levels are likely to decline. The US capacity build out is nearing completion. Capacity projects in the pipeline are small scale, brownfield additions (Carole Park, Australia) or post-autoclave value-add capability (more ColorPlus capacity). Asbestos claim payments remain contained at a maximum of 35% of operating cash flow.

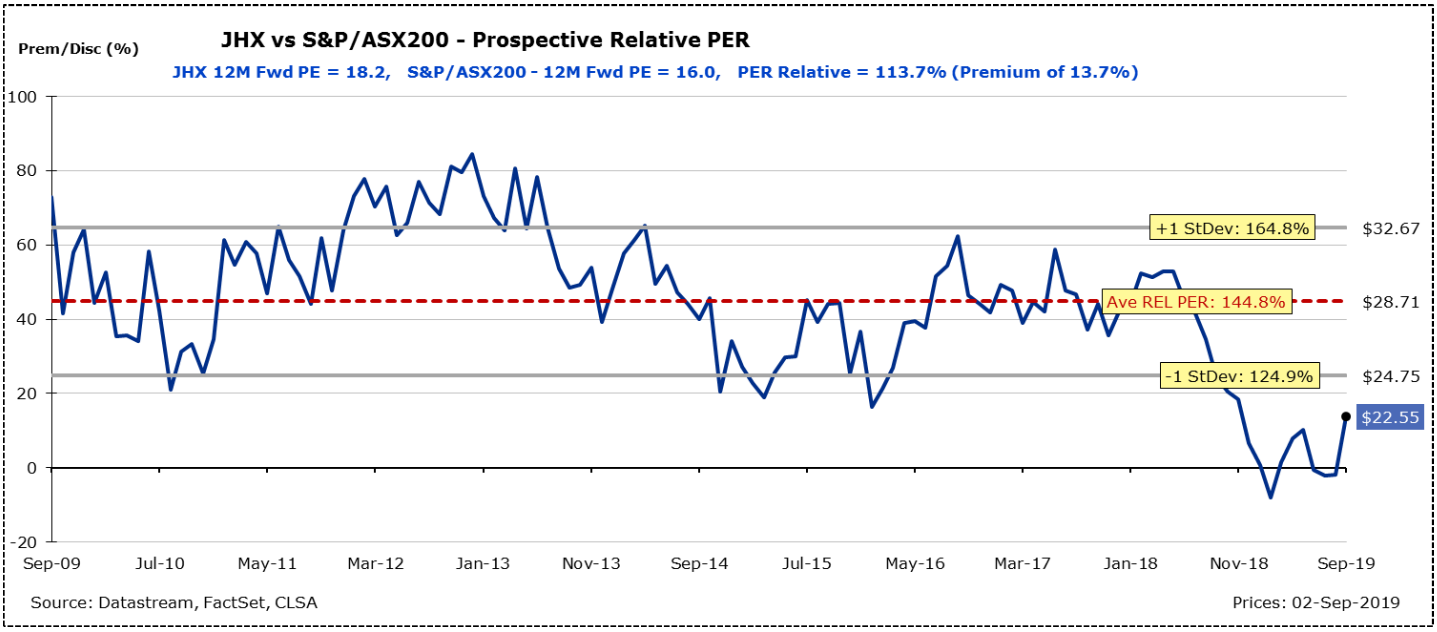
Downward consensus earnings revisions have been a drag on the share price and contributed to the multiple de-rate. Consensus earnings forecasts now look reasonable. Underlying earnings growth of 11-12% in the core US business is easily achievable in the near term with the following assumptions:

- Market volume +3%

- PDG +3% - low end of the management target range (+3-6%)
- Realised price +1.5%
- EBIT margin +1ppt - operating leverage, lean benefits, raw material cost reductions

The earnings multiple relative to the ASX 200 Industrials is back at the same level it was when the US housing cycle was at much more elevated levels and primed to roll over. That is not the likely scenario today and there is certainly not the same potential downside from current 1.2-1.3m US housing starts as there was from 2.0m US housing starts back in 2007. The risk of a material de-rating from here is low. So, if we are right about the upside risk to our relatively conservative US housing activity assumptions, now is the time to build a position.

JHX PE vs the ASX 200 Industrials Index



Our 12 month price target is $24.60. Accordingly, we will look for share price dips to add to the what we believe is a strong business in a cyclical industry, but where the cycle seems to be turning in its favour and market share improvement initiatives are gaining traction.

Macquarie Group (MQG)

On 27 August, MQG announced an institutional placement of $1 billion of new shares at $120, representing a modest discount of around 3% to the previous night's closing share price. A Share Purchase Plan is to follow, which is expected to raise further capital. **The capital raising was primarily to take advantage of attractive investment opportunities**, having recently deployed capital into its key areas of investment focus. **MQG also provided an update on earnings, which indicated that the 1H20 results are expected to be up approximately 10% on the 1H19**. This surpassed the market's expectations of ~ +5%. MQG did not change its previous guidance for FY20 earnings. The upgrade to earnings for 1H20 reflected better operations in its commodities business and a weaker AUD/USD cross rate.

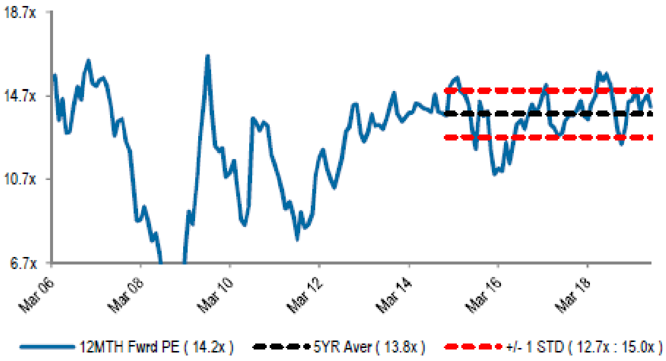
MQG indicated that the 2Q20 is projected to see an approximate $1.6 billion increase in capital usage across annuity-style and market-facing businesses. Final amounts are subject to completion rates and the timing of transactions, but net capital investment in 2Q20 is expected to be around $1 billion currently. Recent investments by Macquarie Capital have been in renewables, technology and infrastructure, with significant investments that include a UK offshore wind farm and further investment in a Taiwanese wind farm. Other notable uses of capital in the 1H20 include the increase in mortgage and business banking loan portfolios in the Banking and Financial Services division. As previously disclosed, APRA's implementation of new counter party risk capital requirements will result in an estimated $0.6 billion increase in capital requirements in the Commodities and Global Markets division. MQG still has surplus capital above its regulatory minimum of around $5 billion.

We chose to participate in the institutional placement to strengthen our existing holding. We believe that the MQG management team is among the most disciplined allocators of capital, generating solid risk-adjusted returns in excess of their cost of capital. And true to form, MQG upgraded its earnings outlook – albeit only for 1H20 – despite sounding a more cautious tone at the time of its results and the AGM earlier in the year. The upgrade reflected better results from group's market-facing businesses. The timing of performance fees and substantial realisations (PEXA and Quadrant) in 2H19 boosted that half's earnings, leading the group to remain cautious with respect to the FY20 guidance, given the high base effect.

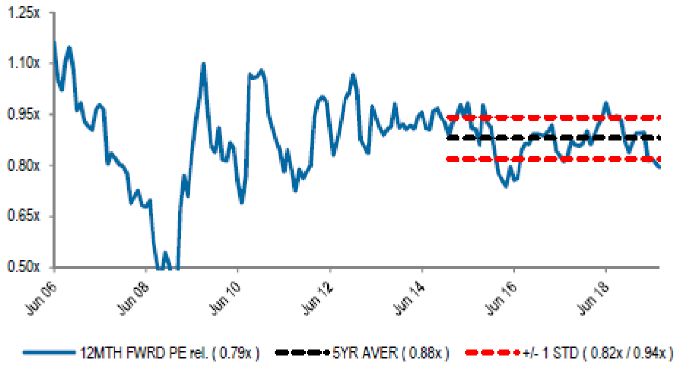
We note that recession risks have risen and markets remain volatile, but the medium-term outlook for MQG is supported by falling bond yields and a weaker AUD. A sustained low interest rate environment and increased market volatility play into MQG's operational skills and the composition of its portfolio. **MQG operates one of the largest global alternative asset managers – MIRA.** Given that MIRA is the main powerhouse of earnings growth, with infrastructure and alternative asset managers trading on significantly higher multiples (for example, Goodman Group trading on a PE of 25x and Transurban Group on 100x offering a yield of 4.1%), MQG is a group well positioned to exploit areas of structural growth like renewables, infrastructure and IT, which overtime, should lead to a rerating. **We continue to remain positive on MQG - it is a high quality, diversified financial company generating solid compounding earnings and dividends (yield of 4.7%), with respected and disciplined management incentivised to deliver superior returns over the long-term.**

MQG's relative valuation is supportive when considered against the Industrials and the major banks. MQG now trades on a PE multiple of around 14x FY20 consensus earnings forecasts (having been de-rated modestly following the full year results earlier this year) versus the Industrials on over 23x. It continues to trade at a discount to our assessed value.

MQG 12-month forward PE



PE relative versus the industrials

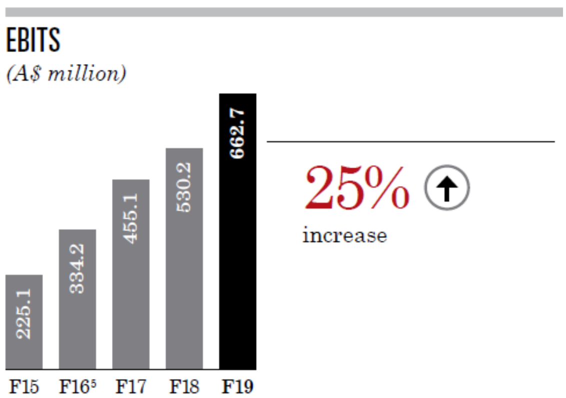


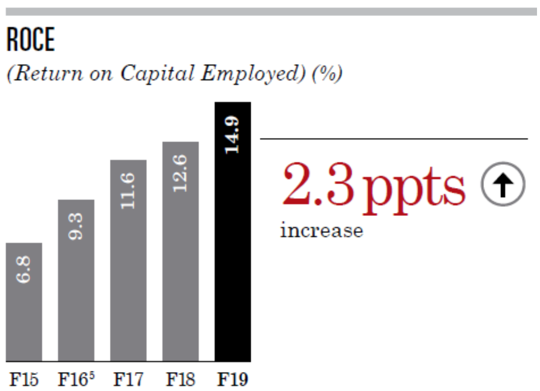
Source: JP Morgan estimates, Bloomberg, August 2019.

Treasury Wine Estates

Quality drowns out the myth makers

Reporting season always throws up a mixed bag of results and FY19 had more than its fair share of howlers. One of the highest quality reports during the season came from one of our high conviction longs, Treasury Wine Estates (TWE). Over the last 12 months, the company has faced a series of accusations from the press and from a short selling campaign. The accusations centred on two key areas: channel stuffing, particularly in China; and poor cashflow conversion with an alleged blowout in receivables and inventory. The high quality 2019 results totally dispelled these myths and delivered an enviable 25% EBITs growth. We believe the strong growth will continue and note TWE has delivered an astonishing 31% compound EBITs growth since FY15, only matched by a handful of industrial companies (mostly in the IT sector). In addition FY19 delivered the 5th consecutive year of ROCE improvement, now standing at a very respectable 14.9%.



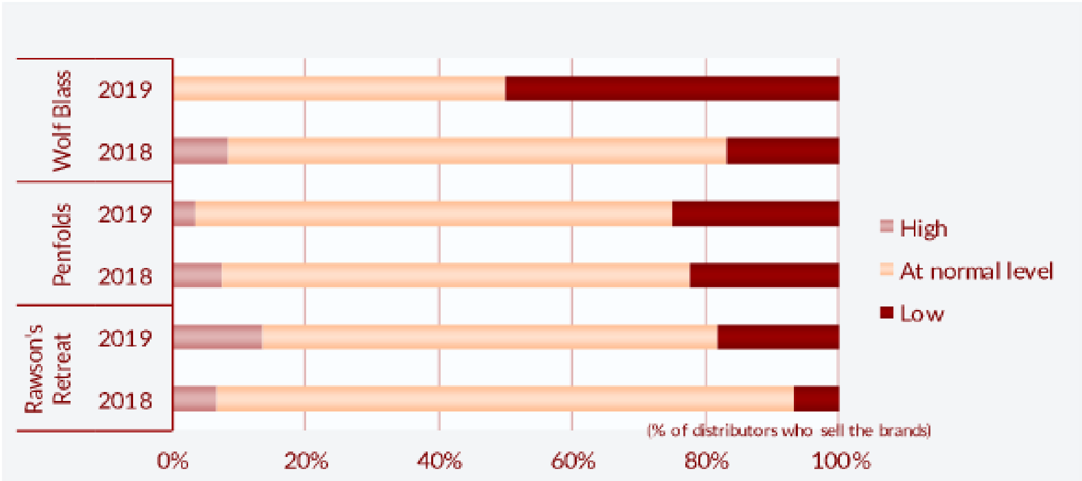


Source: Company Data

Channel primed, not stuffed

The accusation of channel stuffing in China reared its head on several occasions during the year. In part driven by disgruntled distributors, replaced by TWE as it moved to its direct model and also driven by financial market followers fuelled by the high receivables number in 1H19. To gain comfort that the channel stuffing was 'fake news', Ellerston Capital travelled to China and confirmed that inventory levels were reasonable, retailer feedback was very encouraging and pricing remained robust.

Compared to the competing brands at that price range, the inventory of the following brands at your company is:_ _?



Source: CRR

Indeed, respected Asian broker CLSA, through its China Reality Research team surveyed 45 distributors across China and found inventories levels, in particular for TWE's most important brand Penfolds, were lower in 2019 compared to a similar survey in 2018.

Asian results deliver

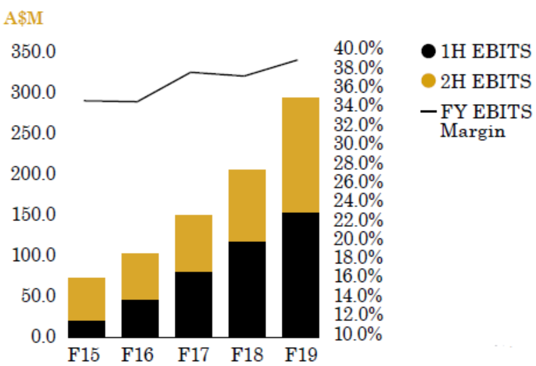
The excellent FY19 results from the Asian region further dispelled the myth that the business was coming under pressure. Volumes sold into the region jumped an impressive 13% in 2H19, revenue leapt 37% for the year and EBITs jumped 43%. A record EBITs margin of 39% is a marker of a thriving business, not one under pressure.

REGIONAL SUMMARIES ASIA

Financial performance

		REPORTED CURRENCY		CONSTANT CURRENCY	
A$M	F19	F18	%	F18	%
NSR (A$m)	748.9	547.6	36.8%	552.2	35.6%
NSR per case (A$)	161.19	125.93	28.0%	126.99	26.9%
EBITS (A$m)	293.5	205.2	43.0%	197.4	48.7%
EBITS margin (%)	39.2%	37.5%	1.7ppts	35.7%	3.5ppts

Historical EBITS and EBITS margin

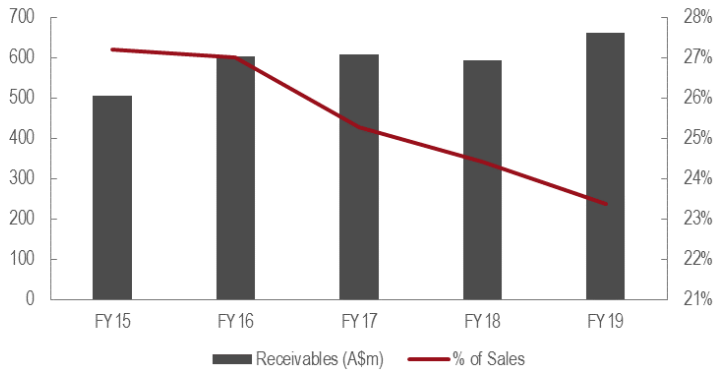


Source: Company Data

Cashflow corrects

The other myth that had perpetuated across FY19 was that poor cash conversion indicated that the P&L as reported, was not a true reflection of the company's earnings. Whilst it is true that the cash conversion in 1H19 was lower than historical levels, the company was clear this was specifically due to changes in distribution channels in both China and the US. By year end cashflow conversion was back above 70% (implying a very strong 2H19 in the 90's) and outstanding receivables as a function of revenue continued to fall.

Receivables under control

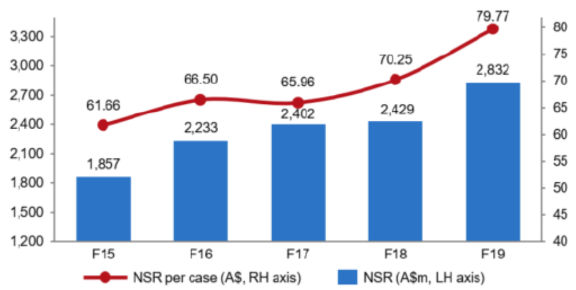


Source: Ellerston Capital Limited

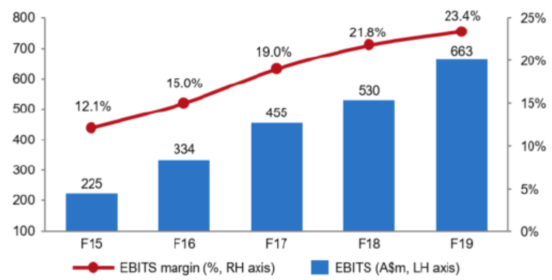
Premium growth set to continue

We remain confident that TWE's growth is set to continue, underpinned by investment in premium inventory. Sales growth has been and continues to be driven by TWE's luxury and masstige brands. Over the last 5 years revenue from these critical brands has jumped from 43% to 69% of total sales, driving both the top line and as importantly, margin expansion.

Premiumisation driving top-line



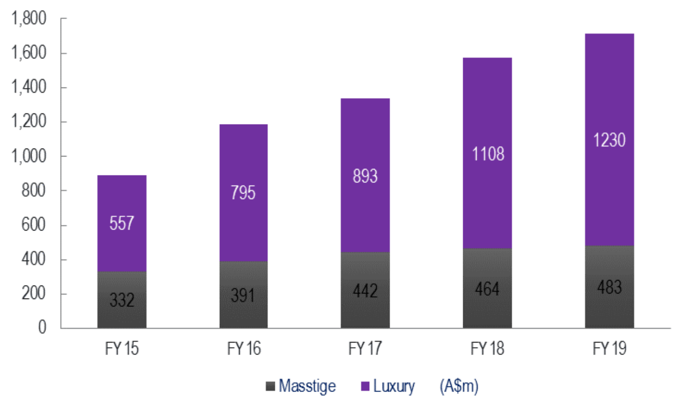
and driving EBIT margins



Source: Company Data

Whilst the above charts tell a good story, it is the investment in premium inventory, particularly luxury, that still gives us confidence that future growth is underpinned. The chart below outlines the investment TWE has poured in to growing its luxury inventory. Over the past 5 years the carrying book value, is up 120% to over $1.2 billion. This has come about through deliberate investment in vineyard assets, improved wine making facilities, geographic expansion and broader relationships with contract growers.

Inventory at Book Value



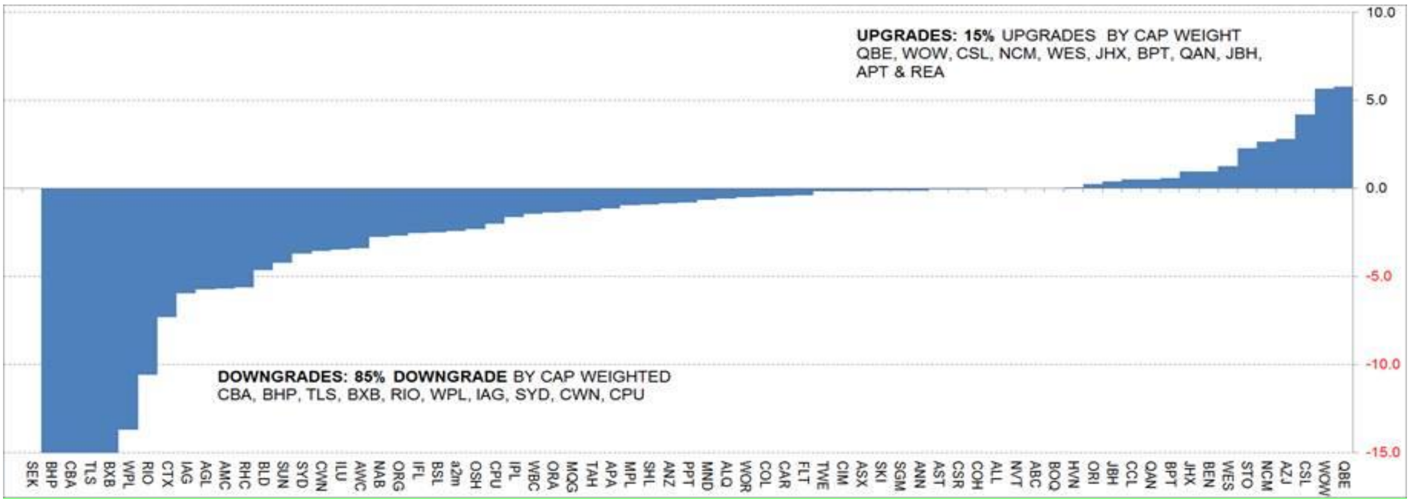
Source: Ellerston Capital Limited

None of this would be viable if TWE hadn't also invested in its brands, market development, consumer fulfilment and retailer engagement. It is the change in relationship with retailers, particularly in Australia, that has most impressed. Historically the relationship with dominant liquor retailers, Woolworths and Coles, has been strained at best and at times adversarial. Significant discounting of premium brands is now a thing of the past, protecting the integrity of signature names like Penfolds and Wynns. Indeed on its most recent conference call, Woolworths publically lauded the success of the Penfolds release in August. With channel management in the US and China critical to the long-term success of TWE, this is a very telling signal of management core competencies. TWE remains a high conviction core holding underpinned by long-term growth prospects.

FUND STRATEGY AND OUTLOOK

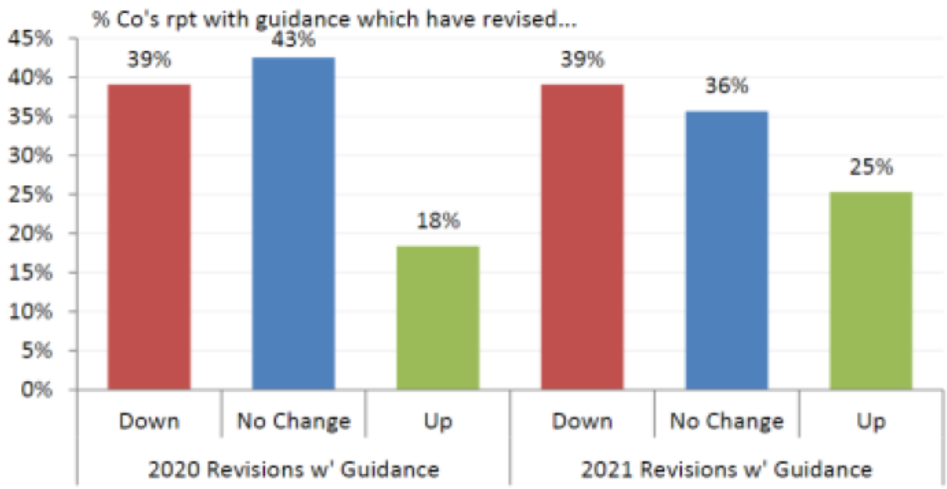
We've just completed a busy reporting season. It was a disappointing season on a myriad of fronts – downgrades surpassed upgrades as tighter credit, an indebted consumer and no household income growth negatively impacted companies' earnings. Offsetting weak domestic growth was valuation support from the lowest bond yields in Australian history. Only a small minority of companies managed to exceed expectations, with the "beat ratio" a meagre 25%. Headline earnings revisions were very weak, with the 1.9% decline in the ASX200 EPS estimate the deepest result season scale-back since Feb-09. Moreover, the proportion of stocks by number seeing downgrades across the ASX300 was nearly 70% – the weakest "breadth" for well over five years

Market capitalisation weighted revisions – the worst reporting season since 2015



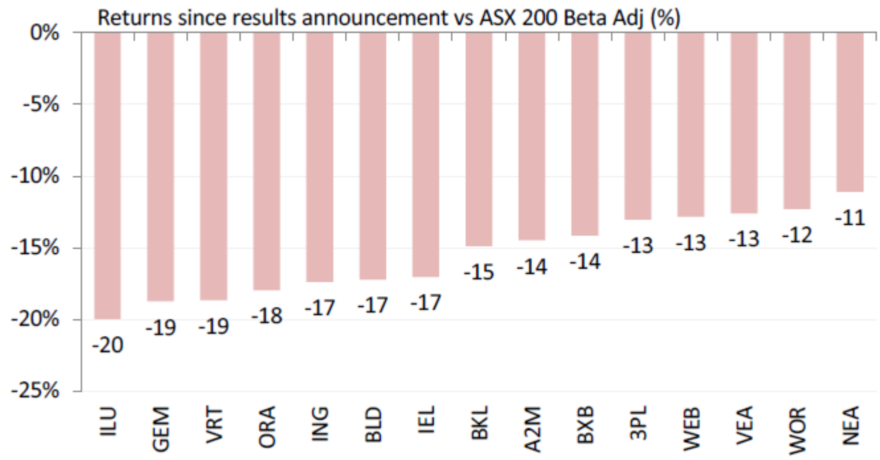
Source: Endeavour Equities

Of the companies that provided guidance, only 18% saw an upgrade to consensus FY20 EPS compared to 39% of companies seeing downward revisions.



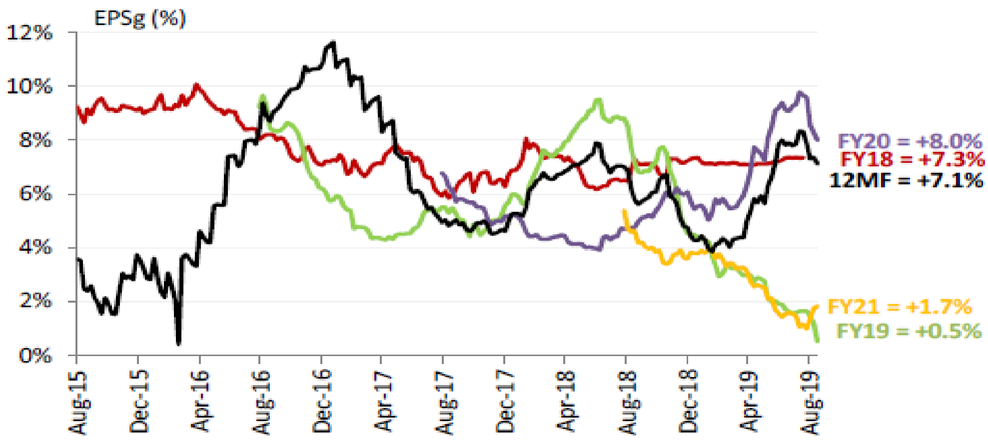
Source: IBES, Factset, Morgan Stanley Research.

We have avoided the stocks that have performed poorly since the results. See chart below of bottom 15 performers since their results were announced.



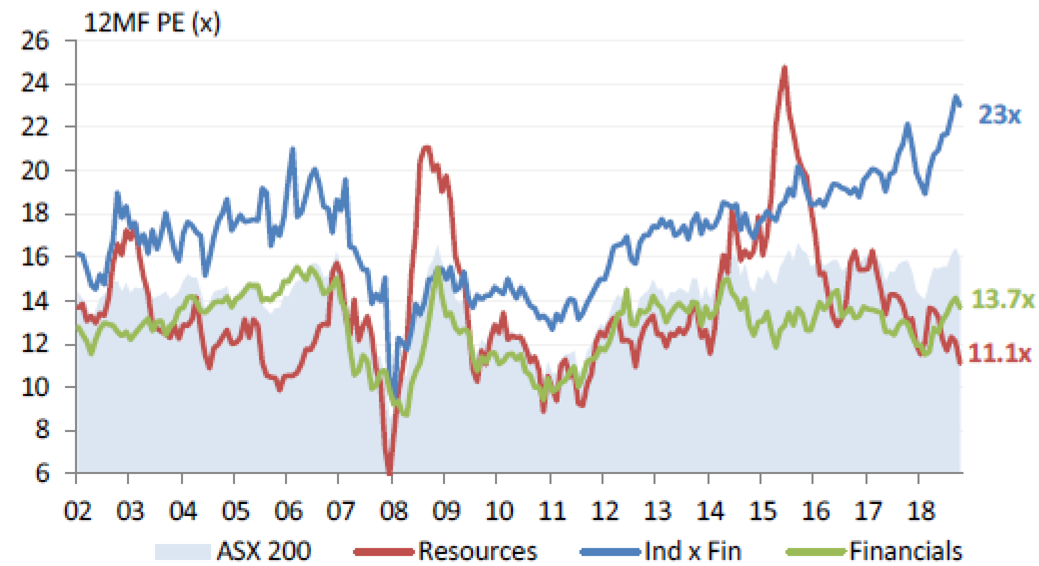
Source: IBES, Factset, Morgan Stanley Research.

Our previously articulated concerns over the absence of earnings growth are being realised. Forward consensus EPS growth for the ASX 200 following the reporting season show that earnings continue to be revised down in the current and outer years, with the market now expecting almost no earnings growth in FY19 and revising down the earnings forecasts for FY20 and FY21.



Source: RIMES, IBES, Morgan Stanley Research.

One of the key themes of the results season was that of PE expansion and the emergence of cost pressure. But despite the absence of earnings growth, valuations remain stretched with the Industrials ex-Financials on 23x.



Source: RIMES, IBES, Morgan Stanley Research.

We remain committed to our bottom up, stock focussed strategy as we seek to identify mispriced stocks where medium to longer term earnings growth is underappreciated.

Our near-term trepidation on the Australian market revolves around earnings, given 80% of this year's rally has been driven by PER expansion.

As outlined in the Activity section, we have been selectively deploying cash as attractive opportunities present themselves.

To summarise your portfolio's positioning:

1. Quality Franchises Solid companies with strong/leading market positions and credible management with good balance sheets *Macquarie Bank, Computershare, Treasury Wines, Aristocrat and James Hardie Industries*	**2. Businesses that are highly cyclical or seasonal in nature, facing certain headwinds** Companies with strong market positions and strategic assets, but very sensitive to economic conditions/seasonality/weather *Graincorp, Nufarm, JB Hi-Fi, Downer EDI and Flight Centre*
3. Turnarounds Sound businesses that have historically generated poor returns, have been poorly managed, under-earned versus their potential, are in transition, and where we think earnings/returns will improve over the medium term. Out of favour with the market, somewhat contrarian positions *Caltex, Orica, QBE and Janus Henderson*	**4. Deep Value Cyclical and Resource Plays** Stocks trading at discounts to NPVs, or with growth optionality, where much of the heavy lifting has been done (cost out, self help) *BlueScope Steel, Woodside Petroleum and Origin Energy*

Still **Zero Big Four Banks**

Warm Regards,

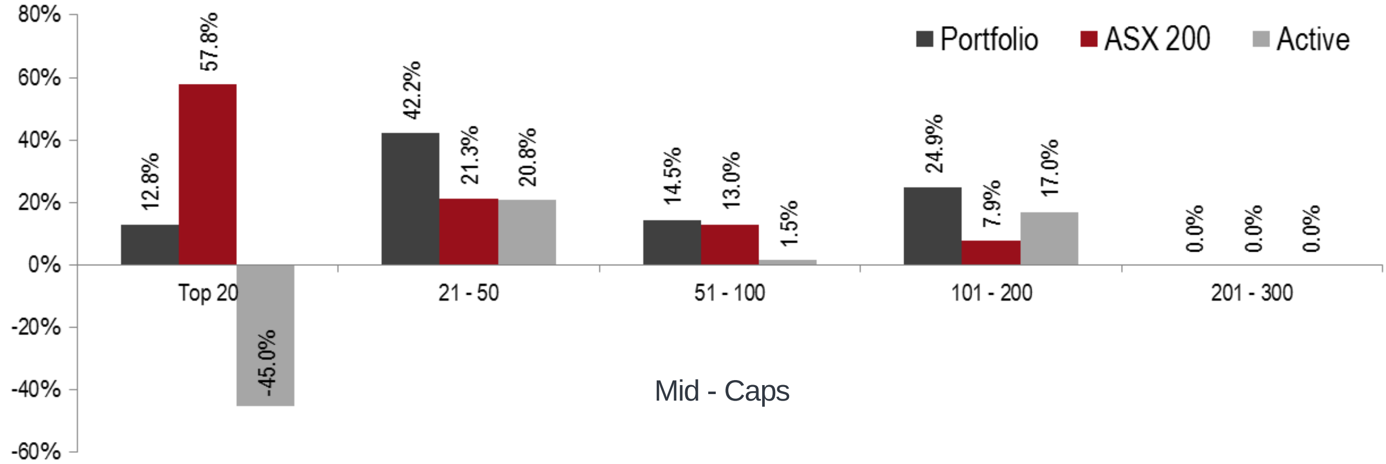
Chris Kourtis

Portfolio Manager

ELLERSTON CAPITAL

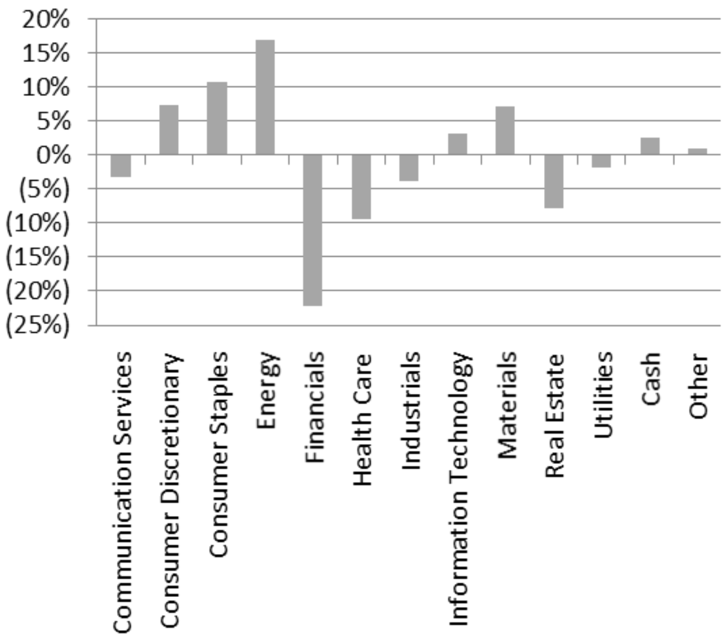
PORTFOLIO FEATURES

Size comparison Chart vs ASX 200^



^Size Comparison Data as at 26 July 2019
Source: Bloomberg, Ellerston Capital Limited

Active Sector Exposures*



Source: Ellerston Capital Limited

TOP 10 HOLDINGS**
ARISTOCRAT LEISURE
CALTEX AUSTRALIA
COMPUTERSHARE
FLIGHTCENTRE
GRAINCORP
NUFARM
ORICA
ORIGIN ENERGY
TREASURY WINE ESTATES
WOODSIDE PETROLEUM

* 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	$3.1 BILLION
FUNDS UNDER MANAGEMENT – ASF UNIT TRUST	$47 MILLION
APPLICATION PRICE	$0.9191
REDEMPTION PRICE	$0.9145
NUMBER OF STOCKS	20
INCEPTION DATE	1 APRIL 2009

Source: Ellerston Capital Limited

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