Ellerston Capital

Ellerston Global Equity Managers Fund (GEMS)

Performance Report | October 19

PERFORMANCE SUMMARY

Performance*	1 Month	3 Months	1 Year (p.a.)	3 Year (p.a.)	5 Yr (p.a.)	Since Inception** (p.a.)
GEMS C	0.86%	2.09%	0.46%	2.78%	9.97%	9.96%

Source: Ellerston Capital

*Net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance

MARKET COMMENTARY

Market Overview

In October, Emerging Markets (+4.2%) outperformed Developed Markets (+2.6%) by a reasonable margin. Financial markets took some comfort from easing geopolitical tensions, with signs that the US and Chinese authorities were edging closer to some agreement on their trade dispute and the UK stepping back from its Brexit precipice. The US Fed cut rates for the third time this year and global central banks reiterated their accommodative stance, which helped bolster investor sentiment.

USA

Against the backdrop of a positive earnings season, the S&P 500 Index made further gains of +2.2% in October, hitting all-time highs at the end of the month. The Dow Jones Industrial Average Index was up a more modest +0.6%. The NASDAQ was the strongest performer, with a return of +3.7%.

US-China discussions on trade oscillate wildly but appeared to be more constructive in general during October. Financial markets were buoyed by the generally positive sentiment on trade. But US economic data suggested that the economy is quickly losing momentum, especially in the trade-dependent manufacturing sector. The manufacturing PMI data indicated that the manufacturing side of the economy is contracting. Consumer confidence was also weaker in October. Not surprisingly, the Fed cut rates by 25bpts for the third time this year but signalled its intention to pause in the easing cycle. Markets took their lead from better than expected 3Q earnings on average and squeezed higher.

Europe

European equities overall were in the black, with the Euro Stoxx returning +1.1%. Among key markets, Germany's DAX was one of the strongest performers with a return of +3.5%. France's CAC 40 was up 0.9%, but the UK's FTSE 100 was down 1.9%, despite the country seemingly stepping back from the Brexit cliff edge. No deal Brexit risks have now faded with the agreement struck between PM Johnson and the EU.

But trade-related weakness globally had a severe impact on the Eurozone and Germany, in particular. German flash PMIs for October remained at 45.7. The ECB saw a changing of the guard: Mario Draghi stepped down and Christine Lagarde, former head of the IMF, took over as President. The ECB last month announced new stimulus measures, but the ECB's toolkit is likely reaching its limits. Ms Lagarde's political skills and persuasion will be called upon to convince European governments to provide further fiscal stimulus.

Investment Objective

The investment objective is to generate superior returns for Unitholders with a focus on risk and capital preservation.

Investment Strategy

The Fund provides investors with exposure to global markets through a long short equity strategy. The strategy overlays fundamental bottom-up stock selection with global macroeconomic and market outlook.

Key Information

**Class Inception Date	1 December 2009
Portfolio Manager	Ashok Jacob
Application Price	$1.5269
Net Asset Value	$1.5231
Redemption Price	$1.5192
Liquidity	Monthly
No Stocks	83
Gross Exposure	145%
Net Exposure	103%
Management Fee	1.50%
Performance Fee	16.50%
Buy/Sell Spread	0.25%/0.25%

Asia

Asian equities were also stronger in the month on the back of optimism on US-China trade talks. Despite the ongoing violent protests in Hong Kong, the Hang Seng Index was up 3.3%. Japan's Nikkei 225 was again the best performer of the major Asian markets, up 5.4%, followed closely by India's S&P BSE Sensex (+3.9%), Korea's KOPSI Composite Index which was up 1.0%, and China's SSE Total Market Index which returned +0.7%.

The annual pace of real GDP growth in China eased to 6.0% for the third quarter, down from 6.2% in the previous quarter. China's home prices rose at a modestly slower pace in September, with retail sales showing steady growth at 0.7% m/m. The People's Bank of China implemented its second 50 basis point cut to the reserve requirement ratio, with another cut to follow soon.

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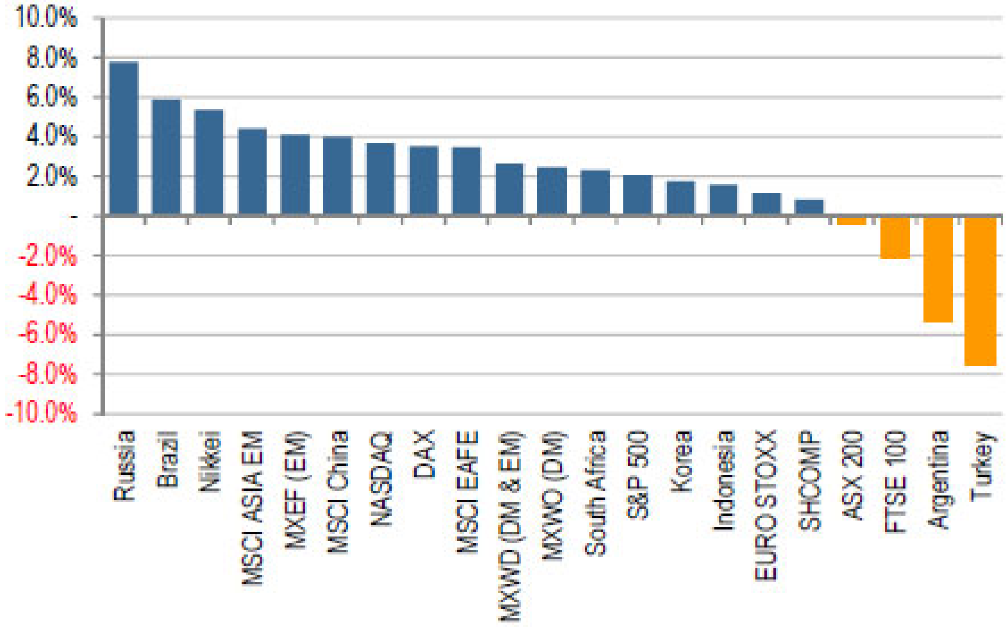
Global Equity Markets' Performance in the month of October 2019

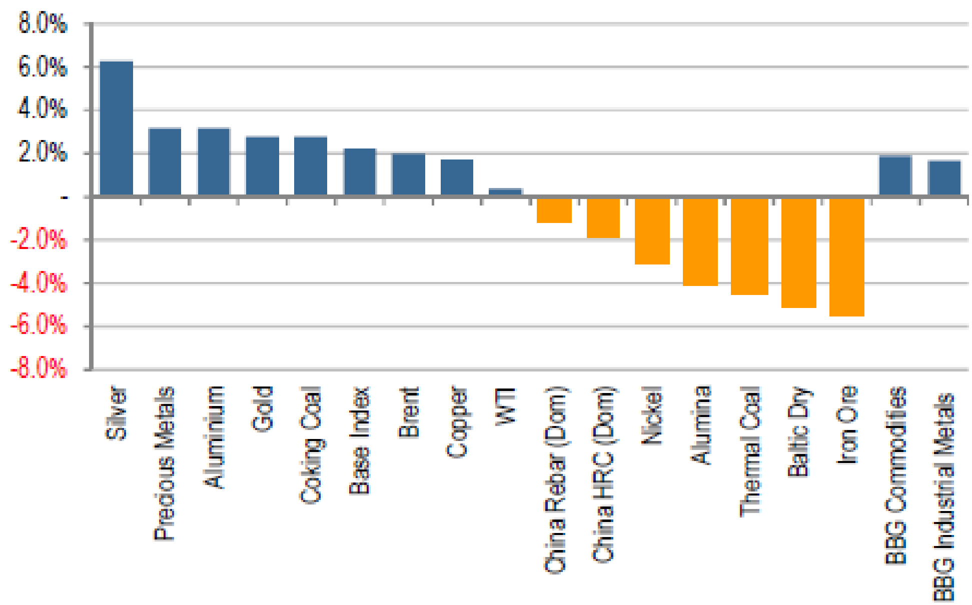


Source: JP Morgan, Bloomberg.

Commodities

The commodities index rose 1.9%. Precious metals were stronger in October, as both Gold (+2.8%) and Silver (+6.3%) shone. Among the bulks, Iron Ore had a poor month, down 5.5% with Thermal Coal weaker too, down 4.5%. Brent was up 1.9% to US$59.62/bbl. Base metals were mixed with Copper up 1.7% but Nickel and Alumina were down 3.1% and 4.1% respectively.

Commodity Performance in October 2019



Source: JP Morgan, Bloomberg.

Bonds

As we saw last month, bond yields appeared to have stemmed their seemingly inexorable decline. The US 10-year bond yield moved up to 1.69% while the Australian 10-year bond yield backed up sharply to 1.14%. The Australian 10-year bond yield is now 55 basis points below the US 10-year bond.

Australia

It was a bad month for Financials, with the S&P/ASX 200 Accumulation Index finishing down 0.35%. The ASX 200 Industrial Accumulation Index posted a negative return of -0.5%, with the Small Ordinaries Accumulation Index also returning -0.5% and then the ASX 200 Resources Accumulation Index, with a return of -1.6%.

The RBA cut rates in October by 25 basis points as expected and noted in last month's update. The RBA's statement said that rates could be cut further "if needed to support sustainable growth in the economy, full employment and achievement of inflation target over time". NAB's measure of business confidence showed that it had dropped back to pre-election levels, while confidence fell one point to -0.3. The September employment card looked decent as unemployment ticked lower to 5.2%. The Australian dollar was up 2.1% against the US dollar, and ended the month at 0.69 cents.

OUTLOOK AND PORTFOLIO COMMENTARY

The portfolio delivered a net gain of 0.86% during October. The portfolio's long exposure at the end of October was 124% while short exposure was 21%. It is important to note that the long exposure includes the portfolio's gold exposure which while a long investment in its own right also acts as a hedge for the long exposure.

Macro

When equity markets have risen over ten years without a sustained pullback, long term experienced investors get nervous. Although there have been many sharp pullbacks, the recoveries have always been V shaped.

The questions to ask here are:

1. How much risk should an equity investor carry? In other words, to what extent should an equity investor be invested?
2. How selective should an investor be? Will a broad index exposure suffice or should there be differentiation between sectors such as growth, value, tech, financials etc.

The answer to the first question lies in the maximum probable loss on a reasonable basis on a market setback or correction. As a consequence of the absolute length of this bull market, this risk is elevated and we saw a dress rehearsal in the last calendar quarter of 2018. Evidently, a 15% correction in one quarter is very possible.

We believe that the biggest risk in the tech and growth markets is not the economy or rate movement. It is simply the risk of overpayment. Value on the other hand appears reasonably priced, good value relative to interest rates and very sensitive to an improving economy. Additionally, the politics around fiscal easing in Europe are improving. Even a negative backdrop in the US is perversely positive as it opens up the possibility of a powerful stimulus in 2020. A relatively high exposure to equities with a strong bias towards value is in our view the right way forward.

Stock Highlight

Macquarie Infrastructure Corp (MIC) is a US listed a company we have followed for a number of years that we recently added as a new position, driven by a catalyst for a material rerating.

MIC owns and operates a portfolio of infrastructure and infrastructure-like businesses in the U.S. The company has a market capitalisation of $3.61b, net debt of $2.45b, estimated 2019 underlying EBITDA of $573 million, and a dividend yield of 9.5%. Over the past twelve months, MIC has divested non-core assets enabling it to reduce debt by $1 billion and optimise the portfolio to three core businesses, two of which make up the majority of the earnings.

IMTT - MIC owns International-Matex Tank Terminals (IMTT), one of the largest independent bulk liquid terminals businesses in the U.S. IMTT owns and operates 17 terminals in the U.S. and two terminals in Canada (one partially owned) that together provide storage and logistics services for more than 48 million barrels of refined petroleum, chemical, and agricultural product tankage. 45% of group EBITDA. For more information visit: http://www.imtt.com

Atlantic Aviation - MIC's airport services business, Atlantic Aviation, provides fuel, terminal, aircraft hangaring and other services primarily to owners and operators of general aviation (non-commercial) aircraft.

Atlantic Aviation operates at 70 locations and represents one of the largest networks of fixed base operations in the U.S. The business operates at some of the most popular business and recreational destinations in the country. 46% of group EBITDA. For more information visit: http://www.atlanticaviation.com

MIC Hawaii - MIC Hawaii comprises Hawaii Gas and other smaller businesses collectively engaged in efforts to reduce the cost and improve the reliability and sustainability of energy in Hawaii. Hawaii Gas is the only utility gas distributor and the largest propane distributor in the State. Hawaii Gas operates on the six major islands and serves approximately 68,000 customers. MIC Hawaii also includes the 7 megawatt Waihonu solar facilities and two distributed generation projects serving commercial users under long-term contracts. 9% of group EBITDA. For more information visit: http://www.hawaiigas.com

Source: Macquarie Infrastructure Corporation Investor Factsheet, August 2019

MIC is externally managed by a subsidiary Macquarie Group, which also owns in excess of 15% of the outstanding shares of the company. Three key events have provided the compelling investment opportunity that exists today.

1. **Dividend Cut** (February 2018) - The company had been a star performer post the GFC providing shareholders with extraordinary returns until it stumbled in 2018. When it released quarterly results in February 2018, the company announced that demand for capacity related to high sulphur fuels would decline materially due to regulatory changes and the relevant tanks would need to be repurposed for other products. This had two material impacts: a meaningful decline in capacity utilisation while the tanks get repurposed and an incremental capital expenditure requirement. As a result, the dividend was slashed by 30% and investors punished the shares which fell over 40% in value.
2. **Refocus** – Combined with the dividend cut, the company announced a strategic review of non-core assets and capital allocation, specifically centered around two assets: Bayonne Energy Centre ("BEC") power generation facility in Bayonne, New Jersey and the operating wind and solar generation businesses. Agreements were reached in June 2018 for the sale of BEC and in May 2019 for the sale of the renewables businesses. These sales refocussed the portfolio and enabled debt to be reduced by $1 billion.

   The repurposing and re-leasing of tanks at IMTT has progressed well with capacity utilisation bottoming and now ramping back up on the path to normalised levels. *Macquarie delivered on both objectives that it had articulated to investors.*
3. **Monetize** – On the 31st of October 2019, MIC announced:

   "its intention to **actively pursue strategic alternatives including a sale of the Company or its operating businesses** as a means of unlocking value for shareholders."

   "To facilitate the pursuit of strategic alternatives, MIC also announced that it has entered into a **disposition agreement with Macquarie** Infrastructure Management (USA) Inc. ("MIMUSA"), the external manager of the Company."

   With the restructuring of the portfolio and balance sheet complete, the remaining assets trading at a material discount to what they would likely be worth in the private market, and with a share price appreciation of over 80% required for the Manager to receive any performance fees, the manager has decided to effectively put the company/assets up for sale. We believe that if the sales process is successful, shareholders could see a return of 20% to 30% over the next 12 to 18 months. The shares are currently trading only 3.6% above their average price over the past 12 months.

   Macquarie as the external manager is heavily **incentivised to achieve an outcome** that would be very beneficial to and is largely aligned with all shareholders.

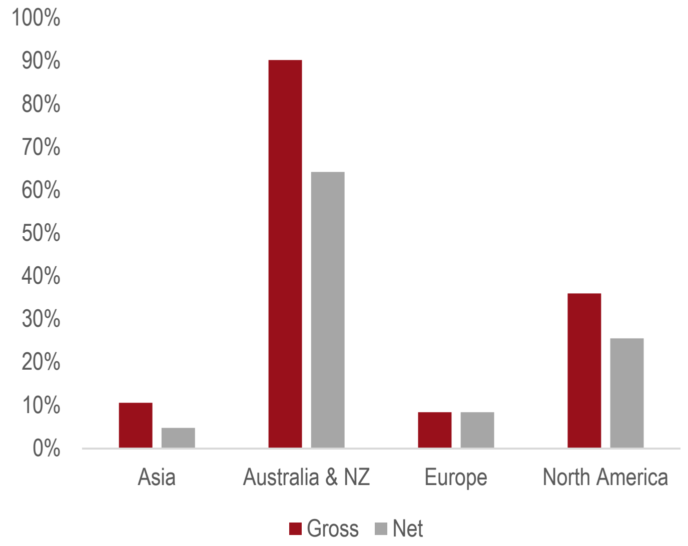
   Currently Macquarie owns shares valued at circa USD$550 million and receives a management fee of circa USD$33 million. Under the disposition agreement entered into with the manager on 30 October, 2019, the manager will be paid a disposition payment amount that scales up based on the cumulative net proceeds received by shareholders in the event of a sale of the company or its assets. As an example, if the cumulative net proceeds equate to $50 per share (a 19.6% premium to the current price), then Macquarie Group's shares would be valued at circa USD$659 million and the manager would receive a one off fee of circa USD$280 million.

   The macro backdrop for the sale of infrastructure assets should be very robust as last year saw investors pour a record USD$90 billion into infrastructure funds. There are few if any groups that would know the infrastructure sector better than Macquarie Group and it seems highly unlikely that they would put the assets of MIC on the market unless they believed strongly that they could achieve a favourable outcome.

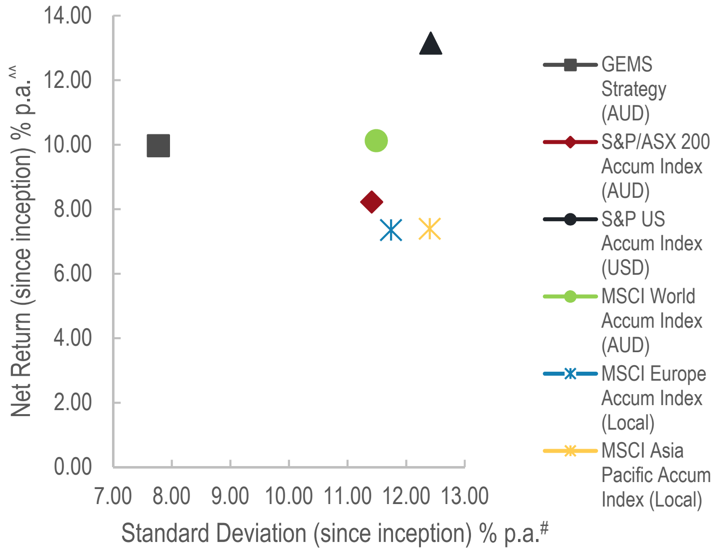
"Show me the incentive and I will show you the outcome." - Charlie Munger

PORTFOLIO CHARACTERISTICS

Market Exposure as a % of NAV



GEMS Strategy Performance & Volatility^



Top 10 Holdings (Alphabetical, Long Only)

- BANK OF AMERICA CORP
- BP PLC
- CATAPULT GROUP INTERNATIONAL
- CLOVER CORP LTD
- GRAINCORP LTD
- JPMORGAN CHASE & CO
- MICROSOFT CORP
- MONEY3 CORP LTD
- NUFARM LTD
- ORICA LTD

All holding enquiries should be directed to our registrar, Link Market Services on 1800 992 149 or ellerston@linkmarketservices.com.au

Should investors have any questions or queries regarding the Fund,

please contact our Investor Relations team on 02 9021 7797 or info@ellerstoncapital.com

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DISCLAIMER

^ Actual performance for your account may vary from that set out in this newsletter and will vary for investments made in different classes, or at different times throughout the year. Some performance data is estimated and preliminary and subject to change.

^^ For the period 1 January 2002 to 30 April 2006, the CPH Group GEMS Portfolio was not operated within a separate fund structure. The underlying investment assets of the CPH Group GEMS Portfolio were owned during that time within corporate entities of the CPH Group for which audited accounts were prepared on an annual basis. Accordingly, in order to provide relevant historical performance information for the period 1 January 2002 to 30 April 2006 (Historical Returns) net returns were calculated on the basis of the actual dollar returns of the CPH Group GEMS Portfolio adjusted to reflect a fund structure similar to the Fund and including all fees. For GEMS B, GEMS A returns have been used between 1 May 2006 and 2 November 2009. The returns of the Fund and the relevant Indices are net of fees, expenses and taxes and assuming distributions are reinvested.

The standard deviation is often used by investors to measure the risk of an asset. The standard deviation is a measure of volatility: the more an asset's returns vary from the average return, the more volatile the asset. A higher standard deviation means a greater potential for deviation of return from the average return of the asset.

The returns and risk of the Fund and the relevant Indices are net of taxes, fees and expenses and assuming distributions are reinvested. The performance figures presented are for the Ellerston Global Equity Managers Fund GEMS C Units. The one month return figure may be an estimate and not the final return. This estimate also impacts other performance information provided. Estimated performance figures are preliminary and subject to change. Returns for other classes may differ slightly. Past performance is not indicative of future performance. Ellerston Capital Limited ABN 34 110 397 674 AFSL 283 000 is the responsible entity of the Ellerston Global Equity Managers Fund ARSN 118 887 095 (Fund). This newsletter has been prepared by Ellerston Capital Limited without taking account of the objectives, financial situation or needs of investors. Before making an investment decision you should consider your own individual circumstances and obtain a copy of the Product Disclosure Statement for the Fund which is available by contacting Ellerston Capital. This material has been prepared based on information believed to be accurate at the time of publication. Assumptions and estimates may have been made which may prove not to be accurate. Ellerston Capital undertakes no responsibility to correct any such inaccuracy. Subsequent changes in circumstances may occur at any time and may impact the accuracy of the information. To the full extent permitted by law, none of Ellerston Capital Limited ABN 34 110 397 674 AFSL 283 000, or any member of the Ellerston Capital Limited Group of companies makes any warranty as to the accuracy or completeness of the information in this newsletter and disclaims all liability that may arise due to any information contained in this newsletter being inaccurate, unreliable or incomplete.