Ellerston Capital

Ellerston Australian Share Fund (ASF)

Performance Report | October 19

PERFORMANCE SUMMARY

Net %	1 Month	FYTD 2020	CYTD	1 Yr	5 Yr p.a.	Strategy Since Inception p.a.
ASF	-0.24	8.48	13.20	6.29	6.42	8.84
Benchmark	-0.35	2.00	22.12	19.28	8.47	10.60

Past performance is not a reliable indicator 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, the UK stepping back from its Brexit precipice, and signs that the US and Chinese authorities were edging closer to some agreement on their trade dispute. 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 in October. Financial markets were buoyed by the generally positive sentiment on trade. But US economic data suggested that the economy is fast 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.

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

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.

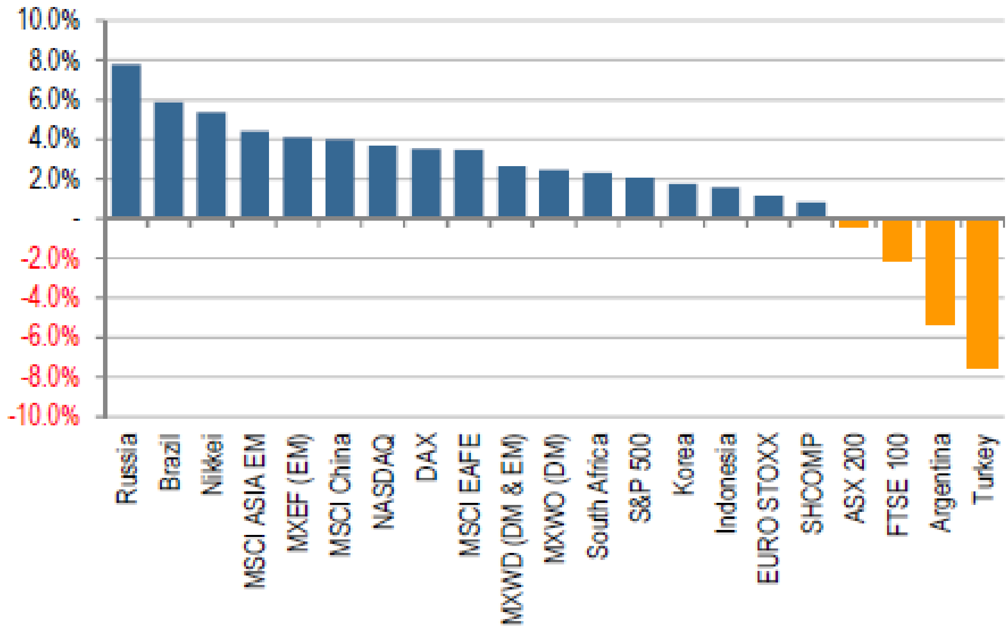
Key Information

Strategy Inception Date	1 April 2009
Fund Net Asset Value	$0.9637
Liquidity	Daily
Application Price	$0.9661
Redemption Price	$0.9613
No Stocks	19
Management Fee	0.90%
Buy/Sell Spread	0.25%
Performance Fee	15%

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.

Global Equity Markets' Performance in the month of October 2019

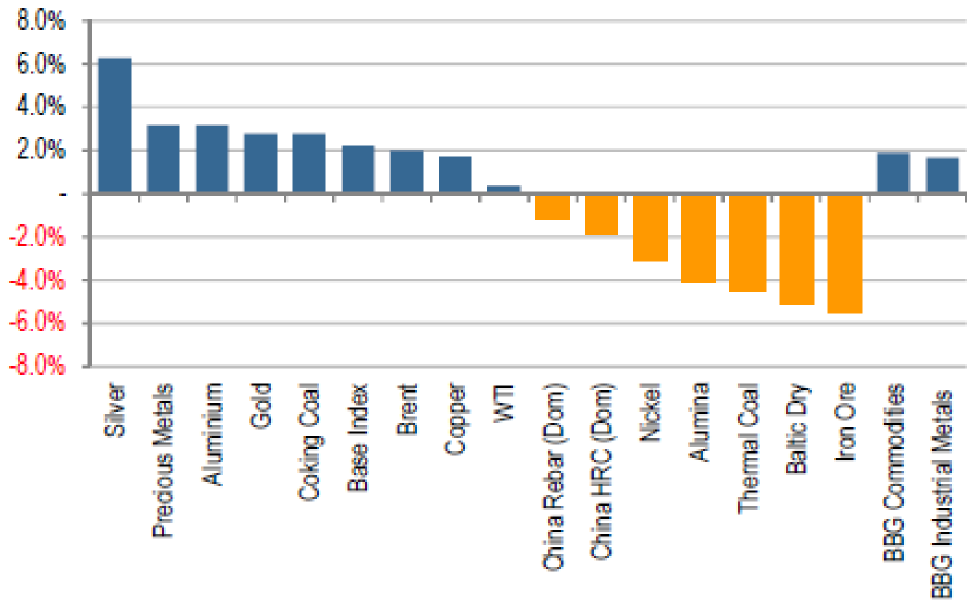


Source: JP Morgan, Bloomberg.

Commodities

The commodities index rose 1.9%. Precious metals were stronger in October, as both Gold (+2.8% to US$ 1,968/oz) 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 index is still up 22.1% for the calendar year to date.

In October, the best three performing sectors in terms of their contribution to the index's performance were Health Care (which surged 7.6%, with CSL up 9.6% the largest contributor to the ASX 200 Accumulation Index), Industrials (+3.0%) and Real Estate (+1.6%). The bottom three sectors were Financials (-2.8%, with all four major banks in the red, making them the largest negative contributors to the broader market index), Materials (-1.9%, with BHP Group and Rio Tinto reversing last month's gains) and Consumer Staples (-2.2%). 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 top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were Australia and New Zealand Banking Group (-29 points), Westpac Banking Group (-28 points), Commonwealth Bank of Australia (-22 points), National Australia Bank (-18 points) and Newcrest Mining (-15 points), post a very disappointing quarterly production update.

The top five stocks that made a positive contribution to the index's return were CSL (+58 points), Sydney Airport (+10 points), Brambles (+8 points), Macquarie Group (+5 points) and Stockland (+5 points).

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.

COMPANY SPECIFIC NEWS

The Market Misses

Southern Cross Media (SXL -33.6%)

The advertising market is under pressure, especially for traditional media operators like Southern Cross that controls metro and regional radio stations (namely Hit, 2Day FM and Triple M) and broadcasts the Nine TV content into regional areas. It issued disappointing earnings guidance for the first half of this financial year that suggests underlying earnings will fall around 20% compared to the same period last year.

Wisetech Global (WTC -24.6%)

Wisetech spent the month in a public argument with short-seller J Capital Research over its financial accounts, predominantly around revenue recognition. The market oscillated between fear and greed on a daily basis, as management and the hedge fund played tit-for-tat. The only thing that's certain, is time will tell who's holding the aces.

Bega Cheese (BGA -21.0%)

At its AGM towards the end of the month, Bega Cheese once again downgraded its expectations for normalised FY20 EBITDA to a range of $95-$105 million (10% -19% below prior consensus estimates). BGA spoke to "unprecedented competitive milk supply conditions and easing demand from third party branded businesses", as the key headwinds to the profitability outlook for the business this year.

Afterpay Touch Group (APT -19.5%)

APT was another tech name caught in an arm wrestle, this time between global banking powerhouses Morgan Stanley and UBS. The former initiated with a price target of $44, whilst at opposite sides of the spectrum, the latter came out with $17.25. The first round clearly went to UBS, which was assisted in its argument that regulatory risk would impact the rating of the stock, as the RBA announced that it was reviewing buy now, pay later services.

Costa Group Holdings (CGC -18.0%)

Costa Group downgraded calendar year net profit guidance by ~50% and announced a $176 million equity raise through a 1 for 4 entitlement offer. Costa Group blamed oversupply, weak mushroom and berry pricing and lower yields on citrus and avocados due to draught conditions. The equity raised will be used to repay debt and support the company's continued growth strategy, where the company has invested over $400 million in capex since their IPO, leaving the balance sheet stretched.

Resolute Mining (RSG -14.8%)

Resolute Mining revealed that the roaster, a key component of the sulphide processing circuit at the Company's Syama Gold Mine in Mali, was taken offline due to the detection of a crack in the main external shell. Repairs will take some time and expense and is likely to materially reduce production from the mine in the December 2019 Quarter, and potentially beyond.

Galaxy Resources (GXY -14.6%)

Enormous over supply of lithium continues to weigh heavily on the Galaxy Resource's share price. Galaxy has been forced to scale back its production plans for 2020 by 40% to ensure it is not supplying material at a loss.

GWA Group (GWA -14.5%)

Operating conditions are deteriorating for most companies exposed to residential construction. GWA, the name behind bathroom and kitchen brands such as Caroma, Methven, Dorf and Clark, confirmed it is not immune to the downturn at its AGM. Earnings guidance for the FY20 year is approximately 7% below pre-existing market expectations.

Eclipx Group (ECX -12.0%)

Eclipx announced a non-cash impairment of $100m to Right2Drive, CarLoans and carrying value of software. The company is currently in the process of finding a buyer for these assets. Eclipx also announced they had refinanced their debt which should alleviate the concerns about a covenant breach.

Sims Metal Group (SGM -8.4%)

After highlighting weakness in operating conditions only a month ago, particularly in scrap metal prices, Sims quantified the impact at its AGM, suggesting it would be loss making in 1H20. Moreover, any rebound in 2H20 would be muted, with full year guidance of EBIT between $20 million and $50 million, well short of the market expecting $150 million (and $250 million back in August).

The Market Hits

CYBG PLC (CYB +24.5%)

Last month, it finally became clearer that the UK was unlikely to crash out of the EU with no trade deal, a so-called “hard Brexit”. This saw the GBP rally against the AUD and there was generally more optimism about the UK’s economic prospects - positive for CYB, given its retail and SME focus. Also, CYB cleared a legal hurdle that allowed it to start integrating its Virgin Money acquisition and extract synergies. CYB, trading at less than 0.5 times book value, rallied strongly from its significantly oversold levels, but still well short of the A$6.00 plus price levels seen in September of last year.

Clinuvel Pharmaceuticals (CUV +23.7%)

This Australian biopharmaceutical company was granted approval to supply treatment for adult patients with the rare metabolic disorder, erythropoietic protoporphyria (EPP) in the USA. This genetic disorder causes absolute light intolerance and forces patients to lead an indoor or nocturnal existence.

Ardent Leisure Group (ALG +23.7%)

Ardent Leisure was up strongly due to an off market block trade for 4% of the company at a 20% premium to last traded price. This has led to speculation that the company is a potential take-over candidate, further fuelled by Ardent Leisure’s appointment of Goldman Sachs as defence advisors.

Iluka Resources (ILU +17.6%)

The company revealed it has started work on a strategic review that could see its iron ore royalty stream from BHP’s Mining Area C operation demerged from the core mineral sands business, pleasing investors. A final decision is expected to be made in February 2020.

IOOF Holdings (IFL +15.5%)

From its extremely de-rated levels, sentiment towards IFL turned more positive following a few helpful announcements. In particular, IFL received “no objection” notices from OnePath Custodians and the ANZ bank. These were critical for the acquisition from ANZ to proceed. Also, APRA, to the surprise of many, lost the court case it brought against some IFL executives. And finally, IFL’s update on fund flows was positive, indicating that its advice business in particular continued to deliver results, despite the external pressures. While none of these announcements changed the longer-term earnings profile of the group, it was positive for sentiment and the stock was re-rated.

IDP Education (IEL +14.3%)

IDP Education hosted their AGM during the month, with the company highlighting the strong international student demand for their key university markets, particularly from Indian students and the margin improvement they are delivering from investments into their online platforms.

Bluescope Steel (BSL +11.0%)

BSL performed very strongly over the month, as US steel makers, Nucor and US Steel raised prices for hot rolled coil. Price increases of US$40 per tonne or ~8%, provided confidence that the inventory draw down, which has negatively impacted demand over the last 12 months, was coming to an end.

Fisher & Paykel Healthcare (FPH +10.8%)

This manufacturer of products and systems for respiratory care and sleep apnoea received regulatory approval to start selling its new obstructive sleep apnoea full face mask in the US earlier than expected. Additional sales from the early release of the mask, along with higher R&D tax credits and a favourable movement in exchange rates led Fisher & Paykel Healthcare to upgrade their earnings guidance for FY20 by 4%.

Xero (XRO +10.8%)

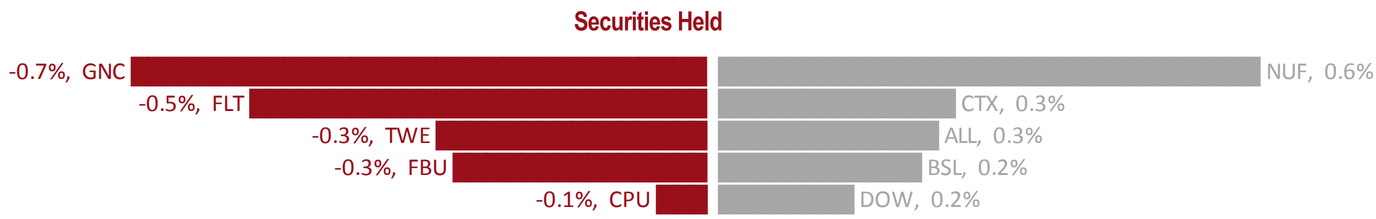
Proving that not all tech companies were ‘on the nose’ in October, XRO was bid up strongly across the month. XRO secured top 10 global accounting firm, RSM Australia, on to its platform which will represent the single biggest migration in the company’s history.

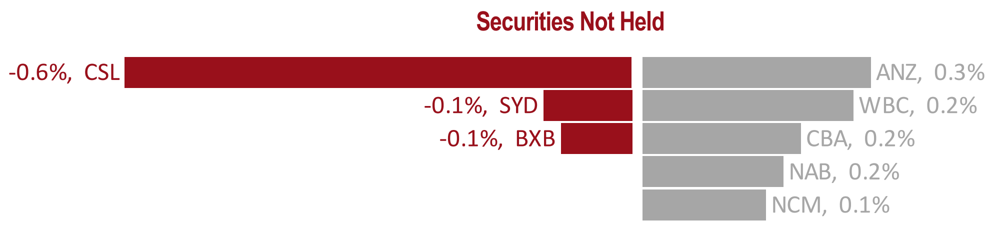
FUND PERFORMANCE

In October, the Fund returned -0.14% and outperformed the benchmark return by 21 bpts, extending the alpha for the new Financial Year.

RETURNS[1] (%)	GROSS	BENCHMARK*	EXCESS	NET
1 MONTH	-0.14	-0.35	0.21	-0.24
2020 FYTD	8.86	2.00	6.86	8.48
CYTD	14.23	22.12	-7.90	13.20
ROLLING 12 MONTHS	7.46	19.28	-11.83	6.29
5 YEARS (P.A.)	7.55	8.47	-0.92	6.42
SINCE INCEPTION (P.A.)	10.02	10.60	-0.58	8.84

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 Nufarm (NUF +5.0%), Caltex (CTX +3.6%), Aristocrat Leisure (ALL +3.3%), Bluescope Steel (BSL +11.0%) and Downer EDI (DOW +3.2%).

Having zero holdings in banks and miners was also a reasonable contributor to performance, with ANZ (ANZ -6.2%), Westpac (WBC -4.8%), CBA (CBA -2.7%), NAB (NAB -3.7%) and Newcrest Mining (NCM -9.9%) all underperforming the market.

The main detractors were the overweight positions in Graincorp (GNC -8.6%), Flight Centre (FLT -10.5%), Treasury Wine Estates (TWE -5.4%), Fletcher Building (FBU -10.5%) and Computershare (CPU -1.9%).

Having a zero holding in CSL (CSL +9.6%), Sydney Airport (SYD +9.3%) and Brambles (BXB +7.7%) on the other hand, 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

No new stocks were added to the portfolio and Fund activity was relatively subdued.

The main activity centred on downsizing the Fund's Nufarm (NUF) holding, following the recent significant rise in the share price.

Post the sale of the Latin America business to Sumitomo for $1.188m (a very attractive multiple of 12.3 times EBITDA) on 30 September, the price reaction was immediate and NUF shares spiked in early October. The divestment results in leverage in the business falling to a pro forma level of 0.7 times. Many investors and potential investors have been concerned over the balance sheet's deterioration, caused predominantly by adverse weather depressing earnings and stretching working capital. This has now been put to bed. We took advantage of the significant rally and sold a big chunk of stock at circa $6.60, reducing the holding. That's 61% higher than $4.10 level that the stock was trading as at 30/6/19.

NEW STOCKS ADDED	STOCKS EXITED

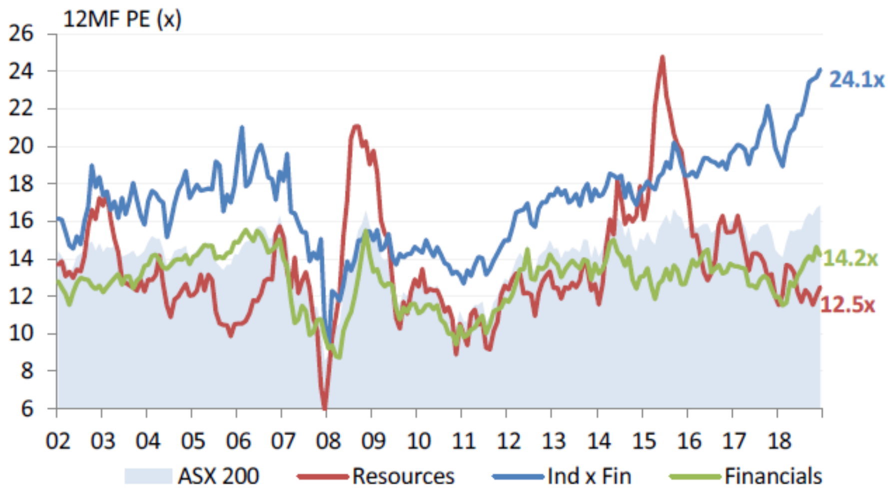
POSITIONS INCREASED	POSITIONS DECREASED
• James Hardie Industries	• Nufarm
• Downer EDI	• Orica
• Caltex Australia	• Janus Henderson Group
• Flight Centre	

FUND STRATEGY AND OUTLOOK

The Australia equity market underperformed other global developed markets as the banks sector underperformed, dragging down the broader market. We highlighted last month the close relationship between the US yield curve and value versus growth. The yield curves in the US and in Australia have continued to steepen. This historically needs to be sustained to support the continued outperformance of value over growth. The economic outlook remains weak and this tends to be the driver of the direction of the yield curve.

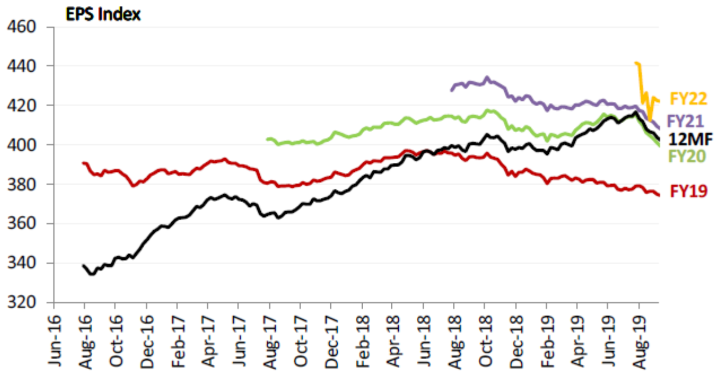
Given this backdrop, we have continued to see earnings fall and valuations get stretched further.

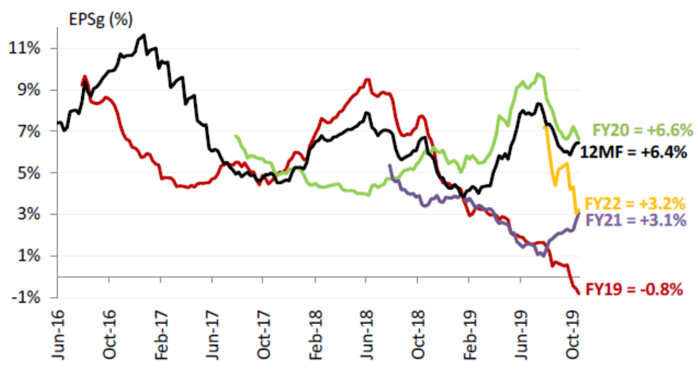
The ASX 200 Industrials ex-financials PE continued to extend further to fresh highs, finishing the month at 24.1x, or over 2 standard deviations over the long-run average.



Source: RIMES, IBES, Morgan Stanley Research.

Meanwhile, earnings forecasts continue to be revised downwards.





Source: RIMES, IBES, Morgan Stanley Research.

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

Our near-term unease on Australian market valuations is driven primarily by the absence of earnings growth. We continue to point out that most of this year's rally has been driven by PER expansion.

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, Goodman Group 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 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*

The major banks have started their FY19 reporting season with ANZ and Westpac having reported their results as we write. As expected, the results have been poor, with their outlook statements worse than expectations. Neither the results nor the underwhelming outlook statements have come as a major surprise to us. As articulated ad nauseam, our negative view on the major banks has been predicated on the following factors:

- Slowing revenue driven by weaker credit growth and compressing net interest margins
- Higher costs coming mostly from increased regulatory and compliance spending post the Royal Commission
- Higher and ongoing remediation charges

- Higher impairment expenses, with an indebted consumer not experiencing wage increases
- Lower earnings and fading returns as a result of the factors above and
- Inevitable cuts to dividends as a result of slower and lower earnings and higher Tier 1 capital requirements.

We had also expected these factors to lead to a substantial de-rating of the sector. **All of our concerns are now being realised.** The only exception has been that impairments remain below normal levels at this stage in the cycle, and the banks' asset quality in their portfolios show little deterioration that's concerning at this stage. This has been attributed to better risk management, continued growth in the economy and very low levels of unemployment at the macro level.

The final, ignominious reality for the sector has been the cut in the dividends. NAB cut early this year, ANZ cut its payout ratio previously and lowered its franking levels to 70% this month, WBC finally cut its dividend and sensibly reset its payout ratio lower to what it feels is a more sustainable level. WBC also raised $2.5 billion of equity capital at a price of $25.32 for potential regulatory action, higher capital requirements and customer growth. **It last raised capital in 2015 at a price of $25.50!!**

There are still capital demands on the sector likely in the near-term, as the final proposals on capital from the Reserve Bank of New Zealand come through in December. **But the attraction of the dividend yield – despite the cuts – in a lower interest rate environment can't be underestimated,** especially from a dividend that's fully franked. Franking is likely to remain a sacred cow for the foreseeable future as governments are unlikely to risk political capital on that issue after Labor failed to convince the public at the last election. Therefore, a fully franked dividend and the implied yield is very attractive to investors, as it is at a substantial premium to official cash rates and available term deposit rates. It is likely that the ratings of the Australian banks will remain above what is theoretically implied by their forecast returns on equity. **The sector has de-rated materially already given the fall in returns, but it is likely to remain stubbornly above where it should theoretically trade.**

We retain a cautious view on the sector, but we acknowledge that **much of our investment thesis is playing out.** The sector has underperformed over many years and sold off from the start of this reporting season. Importantly, consensus earnings forecasts now reflect a more realistic view of earnings, sustainable payout ratios and dividends. Now that the earnings have been re-based and dividends have been reduced (with WBC trading at a 6% fully franked dividend, post the dividend cut), we are looking closely at the sector with a view of participating in over-sold opportunities as they present themselves. We recognise the increased attraction of a fully franked dividend in this historically low interest rate environment facing investors.

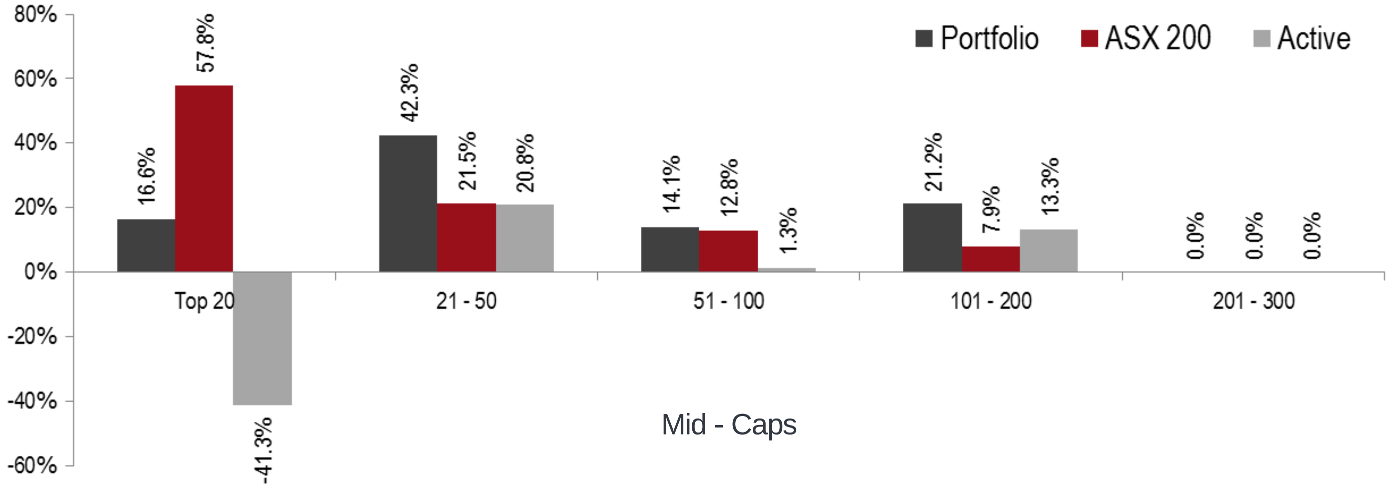
Warm Regards,

Chris Kourtis

Portfolio Manager

PORTFOLIO FEATURES

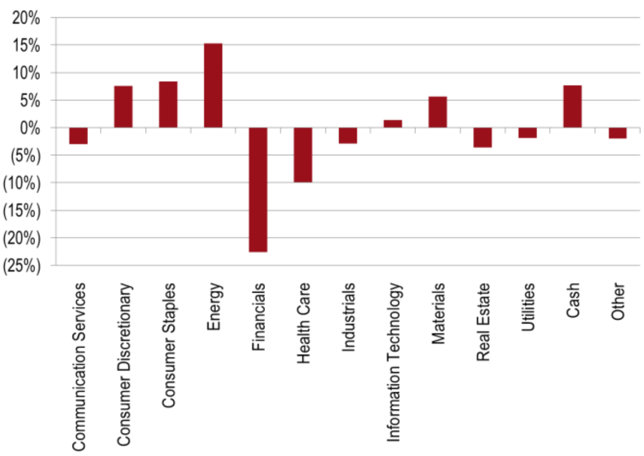
Size comparison Chart vs ASX 200^



^Size Comparison Data as at 25 October 2019

Source: Bloomberg, Ellerston Capital Limited

Active Sector Exposures*



Source: Ellerston Capital Limited

TOP 10 HOLDINGS**
ARISTOCRAT LEISURE
CALTEX AUSTRALIA
DOWNER EDI
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	$43 MILLION
APPLICATION PRICE	$0.9661
REDEMPTION PRICE	$0.9613
NUMBER OF STOCKS	19
INCEPTION DATE	1 APRIL 2009

Source: Ellerston Capital Limited

For further information, please contact:

INSTITUTIONAL CONTACT

Andrew Koolman
+61 2 9021 7760
akoolman@ellerstoncapital.com

RETAIL CONTACT

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