

Ellerston Global Equity Managers Fund (GEMS)

Performance Report | January 20

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	4.96%	11.25%	18.22%	6.84%	11.72%	10.86%

Source: Ellerston Capital

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

PORTFOLIO COMMENTARY & MARKET OUTLOOK

Portfolio: portfolio delivered a net gain of 4.96% during January 2020.

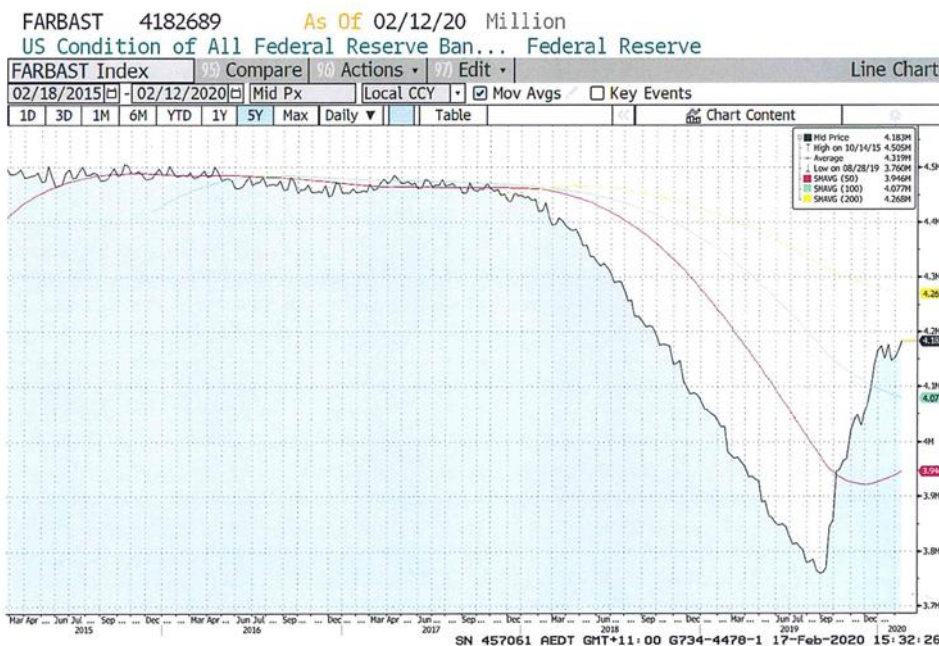
The portfolio's long exposure at January 31, 2020 was 118% while short exposure was 30% providing a net exposure of 88%. It is important to note that the underlying net exposure is materially less when adjusted for the hedging strategies that the GEMS portfolio has in place.

Market Outlook: Six weeks into the New Year, the market has indeed moved up hard. As we indicated in our last newsletter, all lights are flashing green. The US continues its NQE (Not QE) liquidity infusion and interest rates remain low.

Now the question is the impact of COVID-19. We believe that in the absence of it morphing into a pandemic, it may actually be good for the equity risk on trade. Any inflation in the system may well be dismissed as a one off consequent to a supply chain disruption. Additionally, the Chinese reaction to a softer economy can only range between major and seismic. As referred to in our last newsletter, the 2021 Chinese Communist Party anniversary is an occasion of national iconic significance that will not come again soon. A spending induced sharp snap back has the ability to improve business confidence around the world in the second calendar quarter. COVID-19 has the potential to stimulate both Chinese and US monetary and fiscal policy.

Finally, to put up the theme of equity valuations again,

The first chart showcases how rapidly the Fed is ramping up its balance sheet operations.



Source: Bloomberg

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 \$1.6986

Net Asset Value \$1.6944

Redemption Price \$1.6902

Liquidity Monthly

No Stocks 71

Gross Exposure 148%

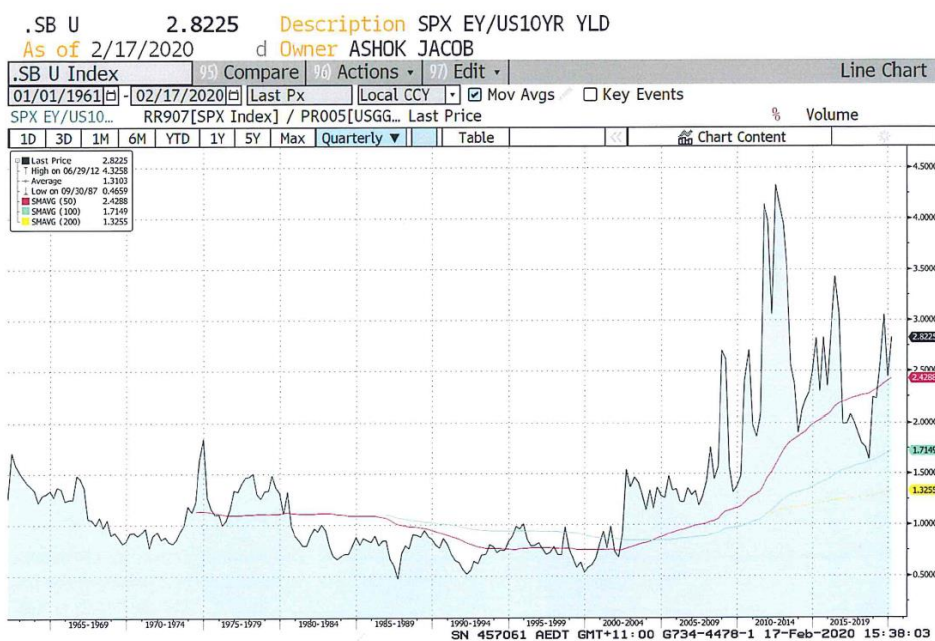
Net Exposure 88%

Management Fee 1.50%

Performance Fee 16.50%

Buy/Sell Spread 0.25%/0.25%

The second chart is a repeat from the last newsletter. The S&P Earnings Yield / US 10 YR Treasury is now at 2.82%. The Ellerston Equity Cheapness Indicator shows that the market became cheaper in January 2020! Why? 10 year treasuries rallied from 1.9% to 1.50%.



Source: Bloomberg

Simplistically, using our EECI, equity markets have only been cheaper three times since 1962. From July 2011 – July 2013, for six months, in 2016 and 3 months in 2019.

When this happened, performance of the SPX following on, was as follows:

	1 Year	2 Years
From 1 July 2013	22%	28.7%
From 1 October 2016	18.2%	37.2%
From 1 October 2019	Currently 15.6%	

The gale-force of Fed easing combined with low rates is a benign tailwind for equity markets of unprecedented strength. This leaves investors no option but to be fully invested but carrying as much portfolio insurance as practically possible without completely destroying portfolio performance.

With that in mind, we are fully invested. However, the amazing performance of markets and the general uncertainty of politics, viruses etc. almost forces us to carry insurance.

Hedging: GEMS currently adopts a three pronged strategy to portfolio protection and capital preservation - at the money index put options and index futures (market volatility protection), out of the money index put options (crash protection), long dated gold call options (tremendous asymmetric risk/reward hedge). We actively manage and adjust these positions with hedging being materially increased during the month of January.

At 31 January, 2020 the face value of cover from index futures and put options was 60% of NAV and the face value of the gold exposure was 40% of NAV. The portfolio has had a very strong start to February.

STOCK FOCUS

DraftKings (Via Diamond Eagle Acquisition Corp. – DEAC)

DraftKings is the #1 global Daily Fantasy Sports (DFS) Company, and a leading participant in both the nascent US sports betting and online casino (iGaming) industries.

We have followed the global online sports betting industry for many years and more recently focussed on the US market as it opens up to legalized sports betting. Post completion of the merger, DraftKings will be the only company that offers equity investors pure exposure to the United States DFS, sports betting and online casino markets.

History

Daily Fantasy Sports: Founded in 2011, DraftKings has built an industry leading 60%+ market share and a database of over 4 million unique paid users with its DFS product being offered in 43 U.S. states.

Sports Betting: In August 2018, DraftKings launched DraftKings Sportsbook in New Jersey after The Professional and Amateur Sports Protection Act (PASPA) was repealed in May 2018, allowing States to individually legalise sports betting. DraftKings became the first legal mobile sports betting operator in the US outside of Nevada. The Company has since started mobile betting operations in 5 states, the most out of any sports betting operator, and also has a retail presence in a further 3 states.

Going Public: On 23 December 2019, DraftKings entered into a 3 way merger agreement with Diamond Eagle Acquisition Corp (DEAC), a publicly listed special purpose acquisition vehicle, and SBTech, an international leading provider of sports betting and gaming technologies. The transaction, which is due to close by mid-2020, will see the listing of the new company called DraftKings Inc. on the NASDAQ.

Business

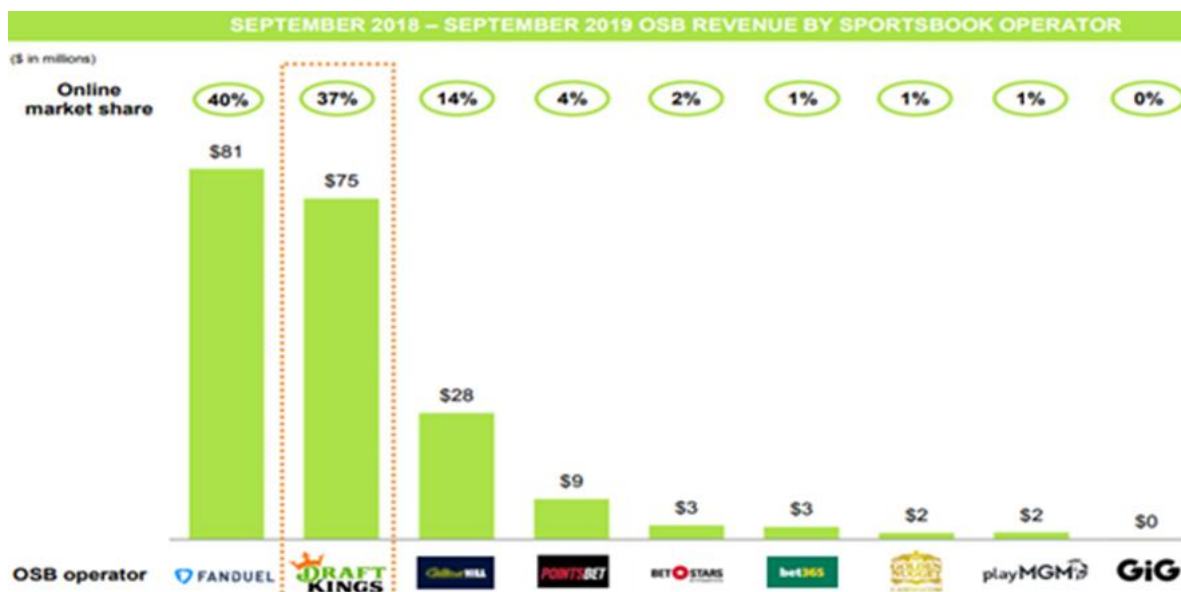
Daily Fantasy Sports is a peer-to-peer platform in which users compete against one another for prizes. Users pay an entry fee (ranging from \$0 to \$10,000 per user) to join a contest and compete against each other in short-duration contests for cash prizes, where the prize money is distributed to the highest performing competitors in the contest as defined by the prize table.

Sports Betting involves a user placing a bet by wagering money on an event at some fixed odds determined by DraftKings. In the event the user wins, DraftKings pays out the bet. Unlike DFS, DraftKings takes some risk on the bet.

iGaming, or online casino, offerings typically include the full suite of games available in land-based casinos, such as blackjack, roulette and slot machines. For these offerings, DraftKings functions similarly to land-based casinos, generating revenue through hold, or gross winnings, as users play against the house.

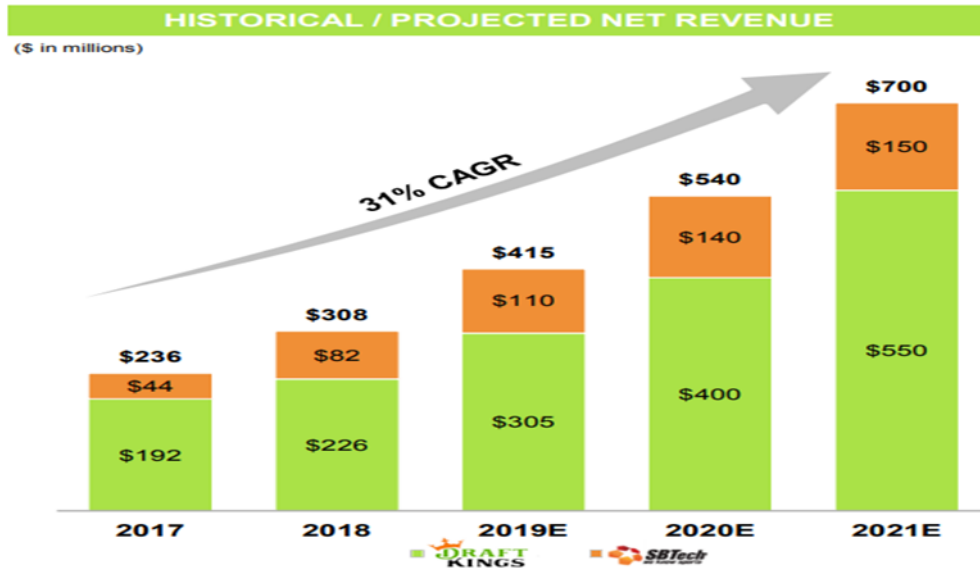
DraftKings currently has the **biggest online sports betting presence in the US with a top 3 market share in every state in which it operates**, positioning itself as an early market leader. DraftKings' **national brand** and **existing DFS customer base of over 4 million users** provides it with a **significant competitive advantage** in the more lucrative sports betting and iGaming markets. It utilises a "one-platform" model with an integrated wallet, allowing users to move seamlessly between its product offerings, opening up **massive cross-selling opportunities**. This is clearly evident as 98% and 40% of all DraftKings' iGaming and Sportsbook customers respectively were initially DFS customers.

DraftKings has achieved and maintained 30%+ market share, despite fierce competition in New Jersey.



A **massive opportunity** exists in the US online sports betting market which is **estimated to generate between USD\$18-23 billion at maturity**, with some estimates being many multiples of that. Currently, only 14 states, representing approximately 24% of the US population, have legalised online sports betting. This could increase to 65% of the US population by 2023, highlighting the massive growth opportunity in the US sports betting market. If DraftKings manages to maintain a 25%+ market share in online US sports betting, it would translate into significant revenue growth for years to come.

Revenue guidance provided by the company at January 2020.



Investment Opportunity

On 23 December 2019, Diamond Eagle Acquisition Corp (DEAC), a US listed cash box, entered into an agreement to merge with DraftKings and SBTech in a three way merger. Under the terms of the deal DraftKings are vending in their business for \$2.1 billion of new stock, while SBTech are vending in their business for \$500 million of new stock and \$200 million cash. Post completion of the merger there will be approximately 331 million shares on issue, of which about 75% will be escrowed for a minimum of six months from the completion date.

For a period of approximately two and a half weeks after the announcement of the merger DEAC traded at an average price of about **\$10.80 per share**. This implied a pro-forma fully diluted market capitalisation of \$3.6 billion and with pro-forma net cash of \$500 million, **an Enterprise Value of \$3.1 billion. It is at this valuation that GEMS acquired the significant portion of its investment in DEAC.**

While it is difficult to quantify the true size of the US online sports betting opportunity, it is clearly enormous. While we don't know who the winners will be, we know that DraftKings is better positioned than most, is one of only two companies that can provide one wallet across three verticals, and has to date executed very strongly.

Valuing non-traditional, new frontier businesses like DraftKings is difficult, however we strongly believe that we have paid the right price to acquire our position and gain tremendous optionality over the growth of the US sports betting industry.

At the current share price of \$17.33, the implied pro-forma enterprise value of DEAC/DraftKings is approximately \$5.2 billion. We continuously re-evaluate the risk/reward dynamic of our investment as the valuation metrics change, as the industry evolves and as the positioning of the participants becomes more defined.

"It's a once in a lifetime opportunity"

- DraftKings CEO Jason Robins discussing US Sports betting in October 2019

MARKET COMMENTARY

Market Overview

In January, fears of the negative impact of the coronavirus on global growth saw global equity markets under pressure, with Developed Markets heavily favoured over Emerging Markets. Australia was the exception, with an impressive return of almost 5% as the market brushed aside concerns that economic growth might be negatively impacted from the bushfires and the virus.

USA

US equities retreated in January, mostly as fears that the coronavirus would hurt global growth took hold of investor sentiment. The US markets had a strong end to 2019, but were quickly thrown off course by the rapid spread of the virus. Both the S&P 500 and the Dow Jones Indices were modestly in negative territory with returns of -0.0% and -0.9% respectively, however, the tech-heavy NASDAQ composite was again in positive territory and bucked the trend, with a return of +2.0%.

Europe

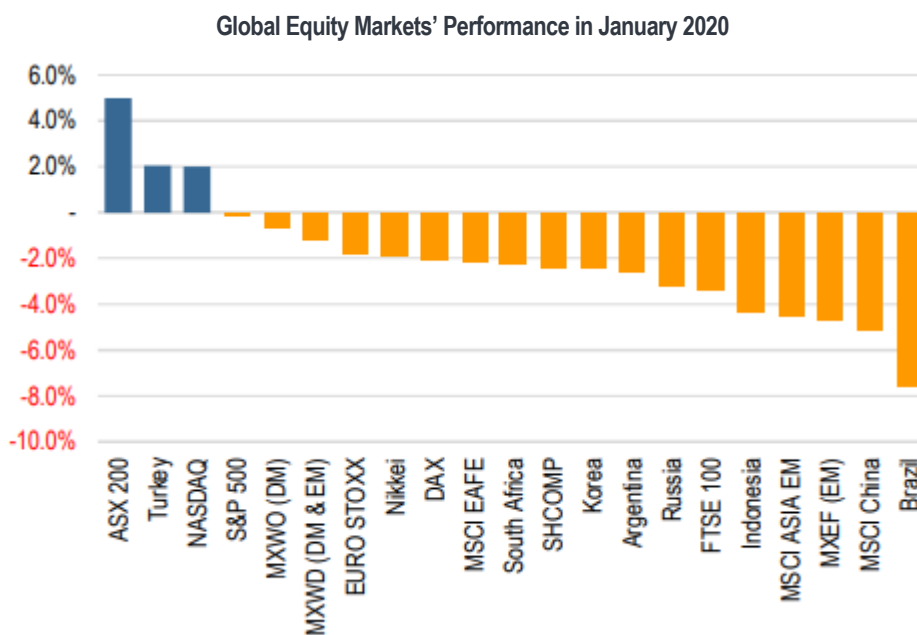
European stocks were weaker following the global lead, also taking fright from the likely impact of coronavirus. Stocks had been very strong the previous month and gave up some of those gains. The Euro Stoxx 50 was down 2.7%, with the FTSE 100 being the worst performer, down 3.4% as the euphoria of the previous month faded and the reality of Brexit took hold. Most other major indices were also in negative territory: Germany's DAX was down 2.0% and France's CAC 40 was down 2.7%.

Not surprisingly, the ECB left rates unchanged through January.

Asia

Asian equities were most severely impacted by contagion fears from the virus and the likely resulting hit to economic growth as markets tried to price in the negative impact from travel restrictions, lower consumption and falling demand, especially from China.

In Hong Kong, the Hang Seng Index was down 6.7%, China's SSE Total Market Index returned -2.9%, and Korea's KOSPI Composite Index was down 3.6%.

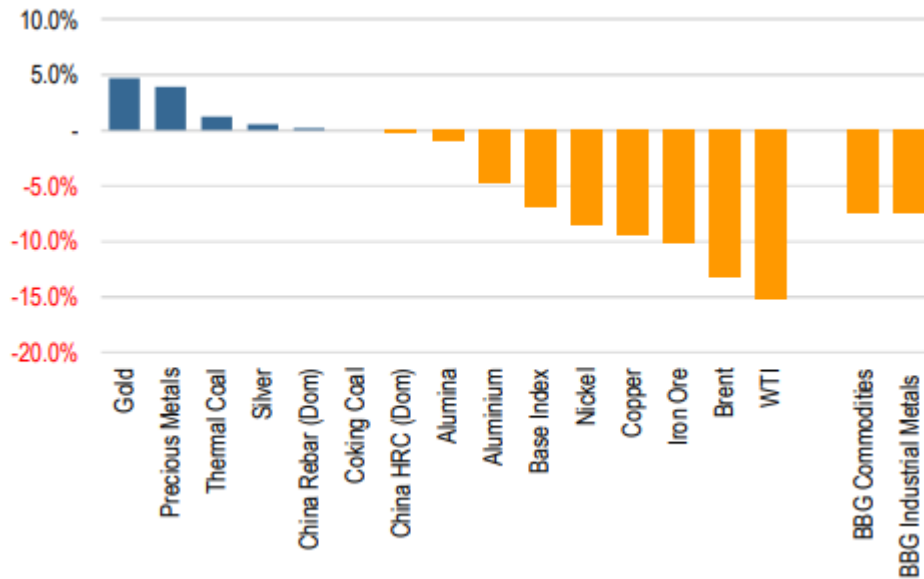


Source: JP Morgan, Bloomberg.

Commodities

Commodities fell across the month, with bulks the worst performers and base metals (with copper slumping 9.5%), followed closely behind as risk-off mentality took its toll. Precious metals rose given their perceived safe haven status, with Gold and Silver up 4.7% and 0.5% respectively. Iron ore was one of the biggest casualties, down 10.1% to \$82.65/t but Brent fell more, down 13.3% to \$56.62/bbl.

Commodity Performance in January 2020



Source: JP Morgan, Bloomberg

Bonds

Global bond yields fell in January as investors took shelter in safe haven fixed income securities. The US 10-year bond yield retraced 36 basis points to 1.56% (just 17 bpts from inversion) and the Australian 10-year bond yield fell 41 basis points to 0.96%, falling below 1%, a level it last breached back in August 2019.

Australia

The S&P/ASX 200 Accumulation Index dismissed the uncertainty surrounding the impact of the bushfire crisis and the coronavirus outbreak and was one of the strongest performing equity markets in the world, delivering a gain of +5.0%.

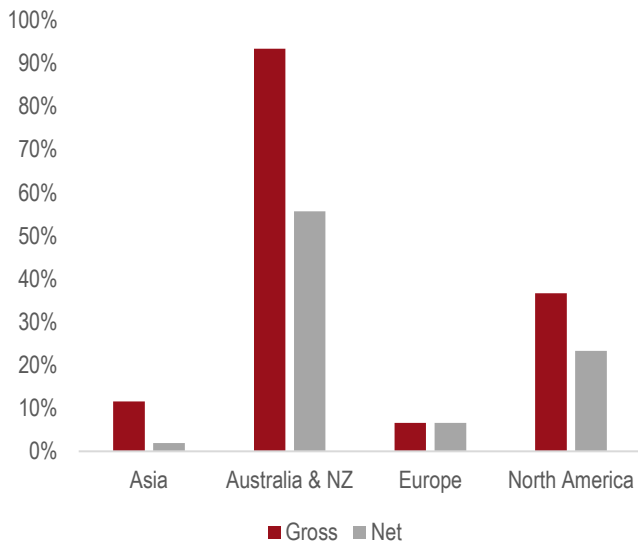
The ASX 200 Industrial Accumulation Index was the best performing sub-index with a stunning return of +6.1%, followed by the Small Ordinaries Accumulation Index (+3.4), while the ASX 200 Resources Accumulation Index brought up the rear with a return of +0.8%.

The RBA left rates unchanged after its meeting in early February.

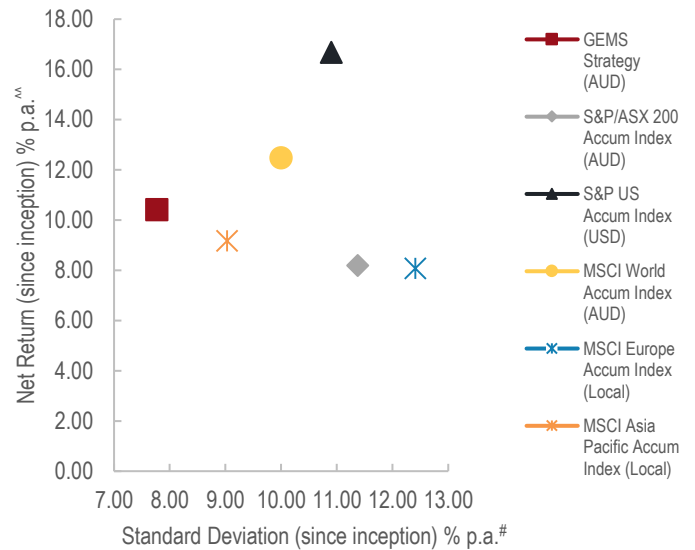
The Australian dollar fell 4.0% against the US dollar in January, and ended the month at 0.67 cents.

PORTFOLIO CHARACTERISTICS

Market Exposure as a % of NAV



GEMS Strategy Performance & Volatility[^]



Top 10 Holdings (Alphabetical, Long Only)

- BANK OF AMERICAN CORP
- CELLNEX TELECOM SAU
- DIAMOND EAGLE ACQUISITION CORP
- GRAINCORP LTD
- JP MORGAN CHASE & CO
- MICROSOFT CORP
- MONEY3 CORP LTD
- NEXTDC LTD
- NORTHERN STAR RESOURCES LTD
- TYRO PAYMENTS LTD

All holding enquiries should be directed to our registrar, [Link Market Services](mailto:linkmarket@linkmarketservices.com.au) on 1800 992 149 or ellerston@linkmarketservices.com.au

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Should investors have any questions or queries regarding the Fund,

please contact our [Investor Relations team](mailto:investorrelations@ellerstoncapital.com) 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.