Ellerston Capital

Ellerston Australian Micro Cap Fund

Performance Report | March 20

PERFORMANCE SUMMARY

Performance	1 Month	3 Months	6 Months	1 Year	2 Year p.a.	Since Inception (p.a.)
Net^	-27.15%	-30.12%	-24.70%	-7.34%	-4.60%	6.98%
Benchmark*	-22.38%	-26.72%	-26.17%	-21.02%	-8.60%	-1.28%
Alpha	-4.77%	-3.40%	1.47%	13.68%	4.00%	8.26%

Source: Ellerston Capital

^ The net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance

* S&P/ASX Small Ordinaries Accumulation Index

Investment Objective

To provide investors with long term capital growth via investing in a portfolio of quality Australian & New Zealand Micro Cap companies. The fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over the medium to long term.

Investment Strategy

The Fund employs an active, research-driven investment approach which seeks to identify and invest in companies that are believed to have the potential to deliver significant upside over the medium term and where there is a reasonable margin of safety to mitigate downside risk. Positions are actively managed within the Fund.

Key Information

Strategy Inception	1 May 2017
Portfolio Manager	David Keelan & Alexandra Clarke
Application Price	$1.1056
Net Asset Value	$1.1028
Redemption Price	$1.1000
Liquidity	Daily
No Stocks	41
Management Fee	1.20%
Performance Fee	20%
Buy/Sell Spread	0.25%/0.25%

COMMENTARY

The Ellerston Micro Cap fund was down 27% during March, underperforming the Small Ordinaries accumulation index by 5%. This violent sell-off was broadly consistent with other equity indices (including large caps), which is somewhat surprising as in prior market downturns the smaller cap companies lead the sell-off. This downturn has been driven by the global spread of the COVID-19 virus, and its far-reaching economic consequences. While the initial bite was felt by the retail, travel, and tourism sector, as the situation evolves it has become clear that very few industries are immune to the economic impact. Many industries which the government has deemed 'non-essential' are unable to operate under the recently introduced social distancing policies.

The market enjoyed some reprieve late in the month, recovering by around 14% in the final week of March. We attribute this rally to the government's unprecedented scale stimulus package which includes wage subsidies, increased and expedited welfare payments, and cash flow assistance/relief for struggling businesses. While the situation has been undeniably challenging, we are starting to see the light at the end of the tunnel. China's COVID-19 cases have dropped materially (i.e. now 3 months in) and businesses are returning to more normal activity and encouragingly, Australia's curve of new cases is showing signs of flattening.

The level of volatility in the market has been exacerbated by high frequency trading and ETF's we are seeing funds forced to liquidate positions (as market caps decrease) to stay within their mandates. This "unnatural" selling is opening up opportunities and liquidity in names we are comfortable to own. We continue to position the portfolio in names with more earnings certainty, structural tailwinds, or lower AUD beneficiaries. We constantly monitoring both downside valuation metrics to ensure our risk/reward ratios remain well placed. Overall, our portfolio construction process has not changed, and we continue to search for high quality companies that give us a 3 to 1 risk/reward or 50% upside over a three-year period.

Portfolio Positioning:

- **Higher weighting to tech/telco related plays -** We believe tech and telco plays offer us more resilient earnings streams given their long-term contracts and recurring revenue streams. Secondly, we believe there is a structural change occurring at an accelerated pace, as a significant portion of the population are forced to work from home. This dynamic is driving increased demand for cloud-based services, along with increased (home) data consumption and internet speed requirements.
- **Uncorrelated investment opportunities –** We have also up-weighted holdings in names which will continue to operate regardless of whether the broader economy is open. Johns Lyng (ASX: JLG) is deemed an essential service and therefore can continue to operate even under the current "shut down". We believe JLG is tracking favourably against its guidance given this did not include any additional catastrophic events which occurred in January and February. In addition, JLG's Restorx (which offers commercial and industrial cleaning services) recently launched a COVID-19 Rapid Response service. We believe this business is performing exceptionally well, as commercial or public buildings with suspected exposure to the virus requiring hospital grade cleaning services.
- **Inflation exposures –** Given the level of stimulus which will be injected not only into the Australian economy but globally, will begin to drive inflation at some point in the future. Consequently, we have added exposure to select gold names given the decoupling of equities to the underlying gold price as well as gold proxies like Zenith Energy (which is also under takeover offer) which offers an infrastructure exposure to producing mines. We also have exposure to names which should do well if governments provide infrastructure stimulus.

Portfolio moving forward

- **Continue holding companies with solid balance sheets –** We have always preferred companies which have strong balance sheets and operating cashflows. This is to ensure when we experience market volatility, our portfolio (despite being microcaps) can weather market movements better than loss-making or highly leveraged stocks. This provides our portfolio with a safety net as our businesses can stand on their own two feet if equity markets or the broader economy weakens.
- **High cash holdings to preserve capital and have powder dry for recaps –** In this current environment our cash holding is sitting at the top end of the mandate. This allows us to be very nimble when opportunities present. These opportunities can either be in our current portfolio where a stock has had an aggressive share price move and we have the liquidity to add to our position at a very attractive price or it may be in regards to placements.
- **Repositioning / up weighting into more quality names** – We have been actively up-weighting in names that we believe offer more defensive earnings (e.g. telco names) with strong balance sheets. We have been de-weighting / exiting positions which require the market to be open. We continue to monitor our level of conviction and while historically our top 10 positions normally represent c35% of the portfolio, this is now drifting towards 40% as stock numbers decrease and we focus on our high conviction, and highest quality names.

Overall, we have seen market valuations fall considerably over the last few weeks. The Small Ordinaries is now trading on a FY20 PE of 17.5x down from its peak of over 20x. However, we would note that while we have seen the price side of the equation fall dramatically, we believe earnings pressure will come through over the coming months. Consequently, while it would appear the market looks “cheap” compared to its long run average, we believe the market PE will reflate in the near term to reflect those downgrades we have yet to seen.

As such we continue to position the portfolio in names with more earnings certainty (benefiting from increased demand; lower AUD; or remote workforces), while constantly monitoring both downside valuation metrics to ensure our risk / rewards ratios remain well placed. In names where we have more data (long listed history), we are reassessing the cyclicality in both earnings and working capital and reviewing these findings against valuation multiples across different periods to ensure our simulations are realistic. Overall, our portfolio construction process has not changed, and we continue to search for high quality companies that give us a 3 to 1 risk reward or 50% upside over a three year period. While nobody can pick the bottom of the market, we have not seen opportunities like the ones in front of us, since post GFC.

Regards

David Keelan & Alexandra Clarke

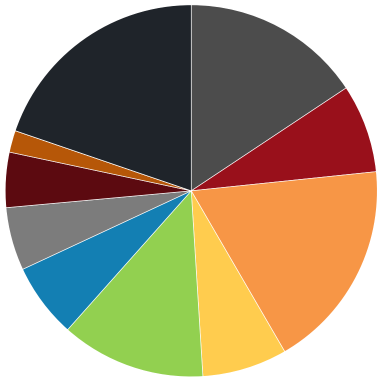
ELLERSTON CAPITAL

PORTFOLIO CHARACTERISTICS

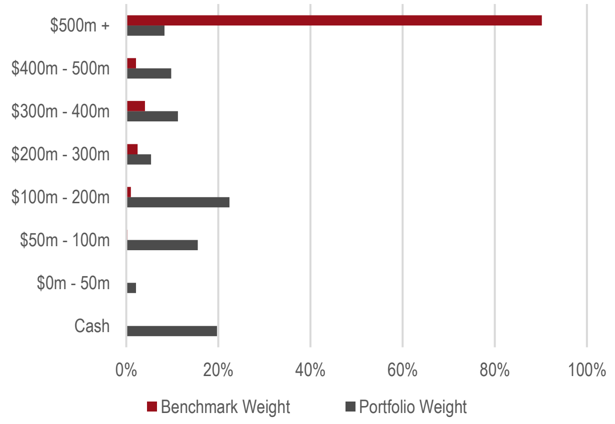
KEY PORTFOLIO METRICS

FY20e	Fund	Benchmark
Price/Earnings	14.8x	17.5x
Dividend Yield	2.1%	3.6%
Net Debt/EBITDA	0.0x	1.3x

SECTOR ALLOCATION



MARKET CAPITALISATION



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 7701 or info@ellerstoncapital.com or visit us at https://ellerstoncapital.com/

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