ELLERSTON CAPITAL

# Ellerston Low-Vol Income Strategy 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^ | -18.57% | -20.88% | -17.41% | - | - | -11.75% |
| Benchmark* | -20.65% | -23.10% | -22.57% | - | - | -16.40% |
| Alpha | 2.08% | 2.22% | 5.16% | - | - | 4.65% |

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 200 Accumulation Index

### Investment Objective

The investment objective of the Ellerston Low Volatility Income Strategy Fund ("ELVIS" or "the Fund") is to provide investors with returns and income growth greater than the S&P/ASX 200 Accumulation Index over rolling 3-5 year periods.

### Investment Strategy

The Fund is a fundamental, bottom up Australian equity strategy with a clear focus on delivering low volatility, sustainable income for investors through actively blending multiple, distinct dividend yield strategies throughout the market cycle.

### Key Information

| | |
|---|---|
| Strategy Inception | 1 May 2019 |
| Portfolio Manager | Chris Hall |
| Application Price | $0.8805 |
| Net Asset Value | $0.8783 |
| Redemption Price | $0.8761 |
| Liquidity | Monthly |
| No Stocks | 33 |
| Management Fee | 0.70% |
| Performance Fee | 10% |
| Buy/Sell Spread | 0.25%/0.25% |

## COMMENTARY

Panic engulfed world equity markets during March as COVID-19 infection rates soared around the globe and governments effectively shut down the world economies by enforcing compulsory self- isolation and social distancing measures for individuals along with the effective closure of many businesses and country borders to foreign travellers. The global response from Governments and Central Banks has been unprecedented, with US$7.0tn of quantitative easing / liquidity measures and US$5.0tn of fiscal stimulus announced so far. Global equity markets and bond yields collapsed, with the VIX (volatility or "fear" index) spiking to levels not seen since the GFC. In Australia, the equity market suffered its worst monthly performance since the October 1987 crash. The Australian dollar troughed at US$0.55 cents before recovering to $0.61 cents at month end and gold attracted "safe haven" fund flows pushing the price to 2013 highs and trading at around US$1,600 per ounce. Finally, oil collapsed to a 17 year low as Russia and Saudi Arabia abandoned supply restraint as global demand was beginning to soften.

***The Fund significantly outperformed** the market in March, falling 18.6% on a net basis compared to the benchmark's decline of 20.7%. The fund therefore outperformed its benchmark by 2.1%. Since inception in May, 2019, the fund has outperformed the index by 4.7% on a net basis. FYTD, the fund has outperformed by 7.1% on a net basis.*

For the month, key drivers of relative outperformance were derived from strong sector and stock performance in Healthcare (overweight Resmed, Sonic Healthcare & CSL) and a meaningful holding in ASX limited & Rio Tinto. These five stocks added 280 bps of relative performance. Also, not owning much of the major banks added another 140 bps of relative performance. Key sector / stock performance detraction came from Materials (owning no BHP and Fortescue Metals) and Consumer Staples (not owning Woolworths but owning Aristocrat Leisure). These stocks detracted 150 bps of relative performance.

Portfolio activity levels were higher than normal as the Fund undertook even further defensive repositioning early in the month. A deliberate decision was made to further lower the funds exposure to mid- cap stocks as they inherently devalue more as liquidity dries up in this part of the market and they are much more susceptible to earnings shocks. Consequently, we exited ARB Corporation, Sealink, Baby Bunting, Credit Corporation and CNI. We also exited our position in Caltex over fears the takeover bid terms will be altered given the declining oil price. These transactions were broadly done at much higher prices. These funds were deployed in large cap stocks with greater earnings and dividend certainty. We initiated a new position in Medibank Private, as their claims expense is expected to collapse due to little/no elective surgery taking place. This will dramatically improve profitability. We also initiated a position In Coles Group early in the month for their defensive supermarket earnings stream. We further added to our existing defensive positions in Spark New Zealand and General Property Trust and increased our exposure to gold via further purchases in Northern Star Resources.

### COVID-19: The Global Macro-Economic Response So Far

Over the past month, the rapid spread of the COVID-19 virus globally has been the catalyst for an unprecedented seizing up of economic activity across a wide range of countries and business sectors. It is clear now that the economic shock from COVID-19 will produce a global recession, as world economies sharply contract over the 3 months between February and April, 2020, recording the biggest quarterly slump in GDP in over 50 years. Full Year Global GDP growth is now forecast to fall 1.1% by JP Morgan at this point, but is likely to move lower. The greatest risk is the rise in global unemployment, as jobs are shed by companies and businesses to try and counteract their respective significant falls in revenue.

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The key question now, is trying to determine the depth and duration of the 2020 recession and the timing and shape of the recovery.

**This will depend on three main forces:**

1. The duration of social distancing policies:

Any recovery in 2H20 will be determined by adjustments to the imposition of aggressive containment measures. Those countries with aggressive containment measures, like China, are expected to see a peak in the number of infections around 10 weeks after the confirmation of cases in each country. The fading of the virus threat, alongside a growing recognition that the economic costs of maintaining aggressive containment policies are large, should begin a process of selective removal of containment measures and a return to work.

2. The success of targeted, co-ordinated policies:

One of the consequences of the global financial crisis in 2008/09 is that policymakers have experience in dealing with acute financial sector stress. As such, they have moved rapidly to negate the impact on financial markets and are working to cushion the blow to corporates and households most impacted by the shock. Ensuring that credit will be provided by the banks, deferring tax payments and subsidising workers laid off are keen areas of focus. Preserving the velocity of money through the economy will be paramount.

3. The magnitude of fiscal and monetary response by Governments and Central Banks:

**Fiscal**

Global fiscal policy responses have focused on three areas: (a) increased healthcare spending targeting the containment and treatment of COVID-19, (b) liquidity measures targeting companies facing severe disruption and liquidity shortages, especially SME's, and (3) support for affected workers to minimise employment and income losses. The size of the fiscal packages currently differs significantly across countries. If we look at the G4 Countries plus China, there has been over US$2.7 trillion of fiscal stimulus announced to date. **The most recently announced additional US$1.0tn rescue plan by the US, which President Donald Trump signed into law on the 29th of March, takes the total fiscal stimulus program globally to 8.0% of world GDP. This is compared to a total of 6.5% during the GFC.**

In Australia, the Morrison Government has rushed through A$320 billion of fiscal stimulus over the past month, (including the massive $130bn Job Keeper package), the largest that any country has unveiled to date on a relative basis. The latest Government package announced on the 30th March is the third round of COVID-19 stimulus, and largest yet for households to "cross the bridge". This has been done as the country prepares for at least six months of economic hardship. Having low Government debt to GDP (20% of GDP) before the COVID-19 outbreak is proving a key differentiator, with other developed countries carrying Government debt to GDP of between 70% and 80% (UK & US). **When coupled with RBA initiatives announced, this figure jumps to a staggering and unprecedented 15.5% of GDP.**

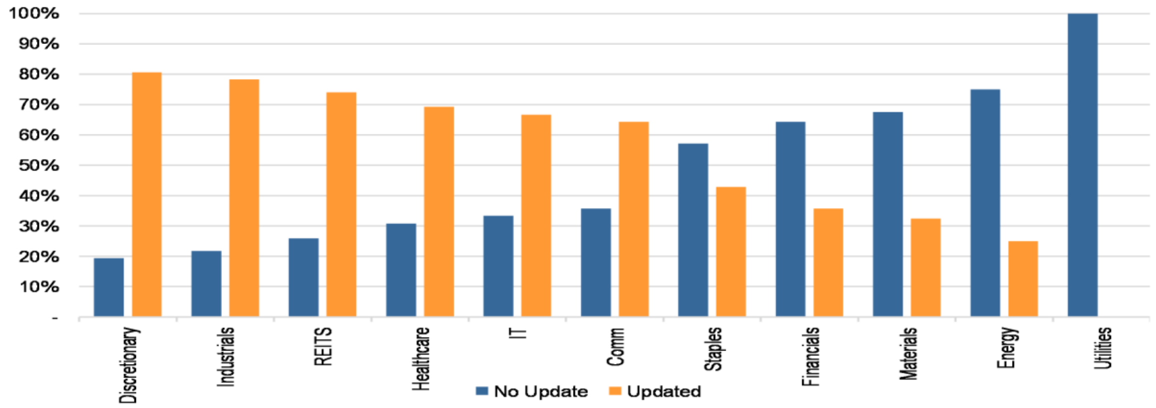
**Monetary**

Since mid-January 2020, 18 of the 30 major Central Banks around the world have eased monetary policy. To date, the global weighted average policy interest rate has declined 0.55% off an already historically low base. In Australia, the Reserve Bank has now cut interest rates to a record low 0.25% and is aiming to keep 3-year bond rates at a similar level.

## What does it mean for ASX200 company and sector earnings?

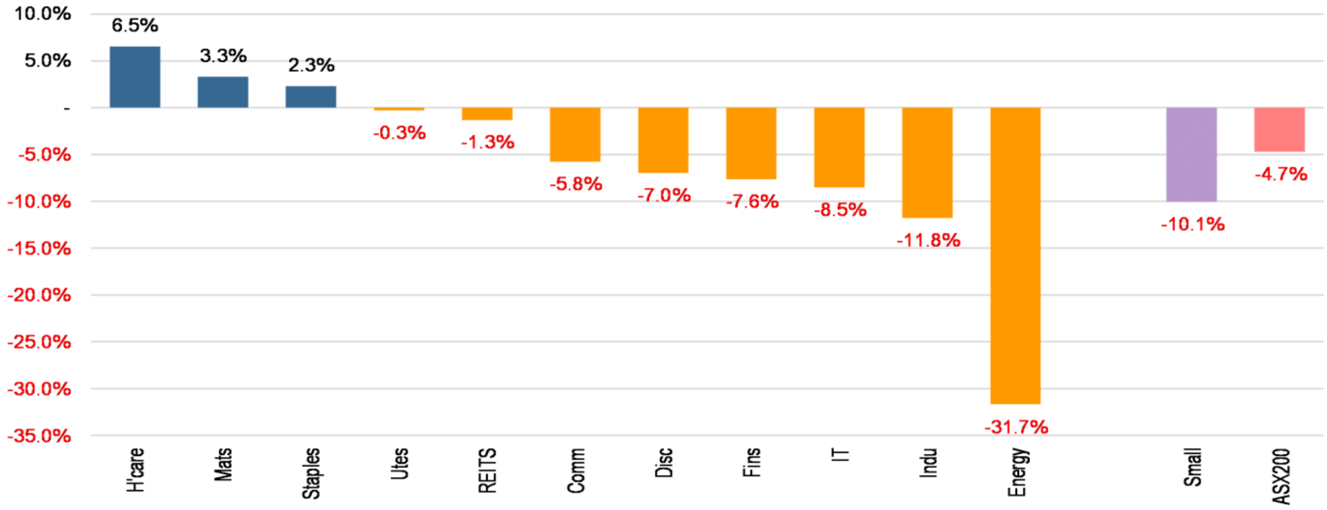
The transformation of COVID-19 from a regional crisis to a fully blown global pandemic has placed unprecedented pressure on Australian company boards to provide the market with updated profit guidance and outlook statements, with many withdrawing previous guidance. A recently released report from JP Morgan revealed that of the 207 companies under their research coverage, 116 have updated the market since the end of February. From a sector perspective, as can be seen from the chart below, Consumer Discretionary has by far seen the largest proportion of updates (80%), while the defensively positioned utilities have, at the time of writing, yet to give a single update.

Importantly, those stocks that have NOT updated the market over the past month have materially outperformed those that have. This is because those that have updated, have subsequently seen meaningful earnings and dividend downgrades.



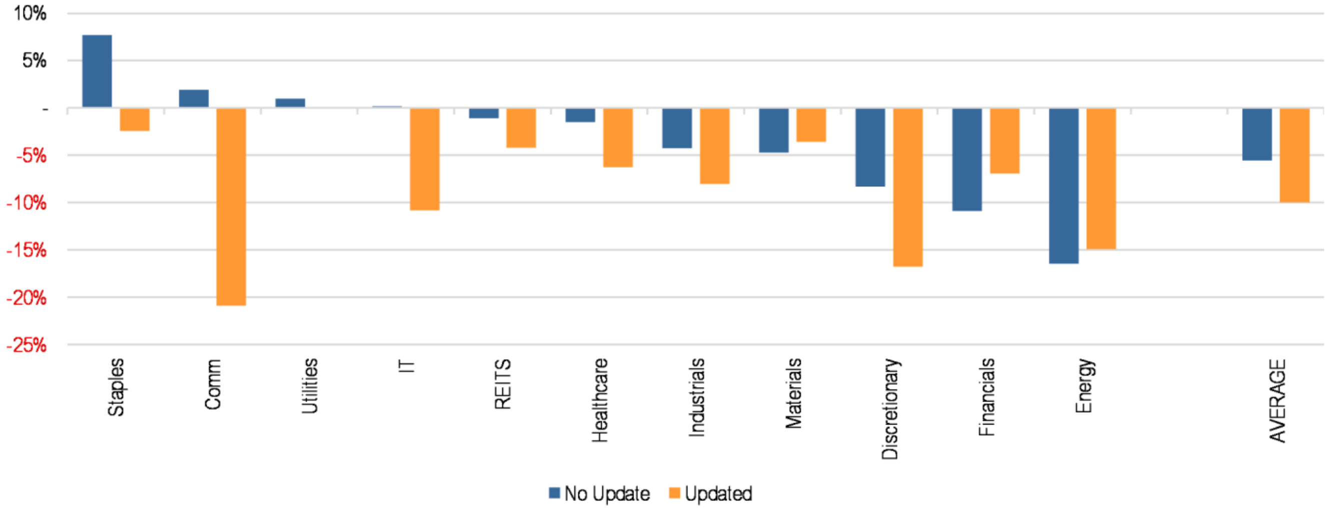

Source: JP Morgan, Bloomberg

The dispersion of sector EPS revisions across the ASX 200 is shown below. Clearly, Energy has seen the largest negative earnings revisions due to the collapse in oil prices.




Source: JP Morgan, Bloomberg

Earnings downgrades have unsurprisingly led to significant cuts in dividend per share (DPS) expectations. Since 20th January 2020, DPS estimates have fallen 11% so far. The biggest sector dividend declines have been in Communication Services and Energy, whereas Healthcare stocks have seen relatively minor downgrades to DPS, as shown below. We expect dividends are likely to be cut further as earnings fall, once companies have more clarity. There is now a healthy debate on the sustainability of some payout ratios especially in the financials sector.




Source: JP Morgan, Bloomberg

During the month we reduced our exposure to the dividend champions yield category as it became more apparent that income from stocks in this part of the market will not be immune from the COVID-19 impact. Consequently, we increased our exposure to defensive yield in order to weather the expected 30% cut in dividends in the market over the next 12 months.

The beta of the fund (a measure of volatility) continued to move lower as a result of our increase in defensive yield exposure. The beta of the portfolio is sitting comfortably at 0.88, below the market beta of 1.00. The expected FY 21 dividend growth rate of investee companies held within the portfolio is above that of the market, at 0.8 % vs -2.1% for the ASX 200, although it is expected that the ASX 200 dividend growth rate will fall substantially from here as companies rebase their dividends from this earnings shock. The expected dividend yield of investee companies held within the portfolio is currently 3.8%.

Regards,

Chris Hall - Portfolio Manager, CIO

Ellerston Capital

# PORTFOLIO CHARACTERISTICS

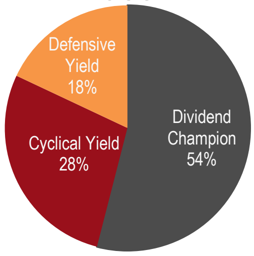
## HOLDINGS

| Top 10 holdings | Sector | % |
|---|---|---|
| CSL Limited | Health Care | 9.7% |
| ASX Limited | Financials | 5.9% |
| Westpac Banking Corporation | Financials | 5.5% |
| Rio Tinto Limited | Materials | 5.3% |
| Resmed Inc | Health Care | 5.1% |
| Goodman Group | Real Estate | 5.1% |
| Dexus | Real Estate | 4.4% |
| Aristocrat Leisure Limited | Consumer Discretionary | 4.0% |
| Spark New Zealand Limited | Communication Services | 4.0% |
| James Hardie Industries | Materials | 3.9% |

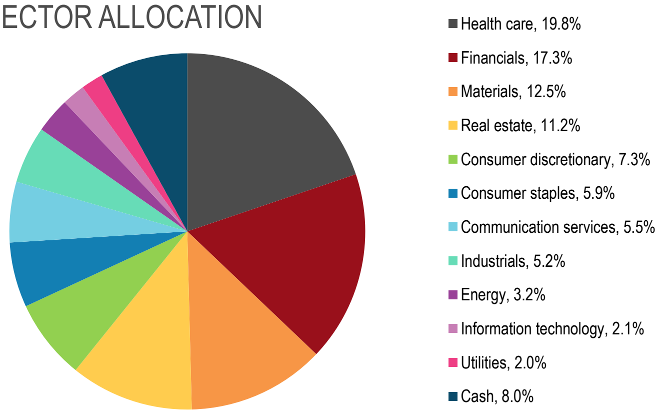
## KEY PORTFOLIO METRICS

| FY21(e) | Fund | Benchmark |
|---|---|---|
| Price/Earnings (x) | 17.8 | 15.4 |
| Dividend Yield (%) | 3.8 | 4.6 |
| Dividend Growth rate (%) | 0.8 | -2.1 |
| Beta* | 0.88 | 1.00 |

## PORTFOLIO YIELD EXPOSURE

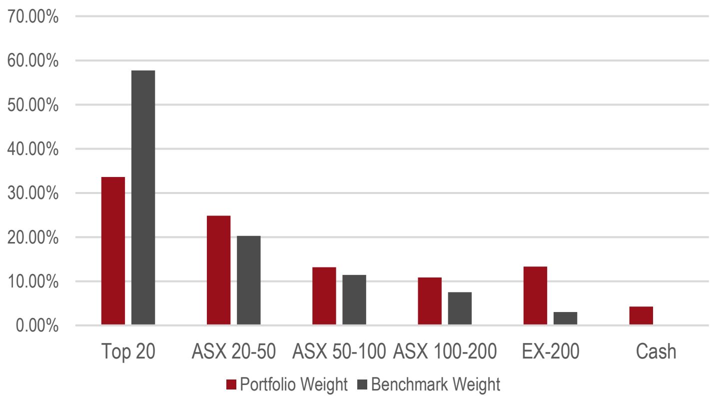



## SECTOR ALLOCATION




Source: Ellerston Capital

## 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,
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