ELLERSTON CAPITAL

Ellerston Low-Vol Income Strategy Fund

Performance Report | April 20

PERFORMANCE SUMMARY

Performance	1 Month	3 Months	6 Months	1 Year	FYTD	Since Inception (p.a.)
Net^	7.34%	-19.06%	-11.66%	-5.27%	-7.27%	-5.27%
Benchmark*	8.78%	-20.32%	-15.48%	-9.06%	-13.78%	-9.06%
Alpha	-1.44%	1.26%	3.81%	3.79%	6.51%	3.79%

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

COMMENTARY

World markets snapped back significantly in April at one of the fastest rates on record as hopes of an end to lockdowns post a peaking of the COVID-19 spread and potential development of a vaccine to treat the virus drove renewed global optimism regarding the pace of expected economic recovery. With continued, unprecedented Government and Central Bank support via fiscal and monetary stimulus measures, the S&P 500 surged 12.8% led by cyclical sectors rebounding (especially energy). The market rally was in stark contrast to the poor economic data released to the market, especially in the developed world. Flash PMI's (purchasing managers' index) were particularly hit hard among the G4 countries. US GDP contracted a significant 4.8% in 1Q while yields on US 10 year bonds remained at record lows, closing at 0.64%. The market rally occurred at a time of accelerating earnings downgrades with 2020 MSCI AC World earnings growth forecasts declining 19.3% so far. It is not inconceivable for global earnings to contract 35-40% this year.

Following on from one of the most violent market draw-downs in history, the Ellerston Low-Volatility Income Strategy Fund had a satisfactory month of April returning 7.3% on a net basis compared to the benchmark's increase of 8.8%, underperforming the benchmark by 1.4%. The Fund's more defensive positioning in quality stocks was the broad reason for this underperformance as cyclical, higher risk stocks rallied hard into the end of the month. Since inception in May 2019, the Fund has outperformed the index by 3.8% on a net basis. FYTD, the Fund has outperformed by 6.5% on a net basis.

Underperformance was driven by larger overweights to more defensive parts of the market. Specifically, Resmed, Dexus Property and Spark New Zealand cumulatively detracted 100 bps of relative performance, whilst not owning Macquarie Group, Scentre Group and Afterpay detracted a further 60 bps of alpha. On the positive side, being underweight the major banks generated 110 bps of relative performance, whilst James Hardie and JB Hi-Fi rebounds added 60 bps to performance, given our overweight stance in these two names.

We need to look at equity income through a different lens

Historically, it's a time honoured tradition that Australian corporates pay out nice juicy dividends to their shareholders, who in turn buy those companies at elevated multiples (at least by world standards). Today, COVID-19 is having a pronounced impact on Australian listed company dividend payments. In the past month alone, we have seen 77% of companies in the ASX 200 cut or cancel dividends, with many more likely to follow. According to research undertaken by JP Morgan, year to date dividend projections have been cut by 19.4%, with Energy (-54.2%), Industrials (-26.6%) and Financials (-26.3%) being the hardest hit. Given Australia has the world's highest payout ratio, it's no surprise that we have seen the deepest negative YTD revisions to dividends. Our 19.4% YTD reduction is meaningful when compared to the MSCI ACWI one-year forward projection, down just 7.6%. Interestingly, with a bigger cut to earnings (-19.3%) the global payout ratio has gapped 600 bps higher to 47.1%.

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	$0.9452
Net Asset Value	$0.9428
Redemption Price	$0.9404
Liquidity	Monthly
No Stocks	33
Management Fee	0.70%
Performance Fee	10%
Buy/Sell Spread	0.25%/0.25%

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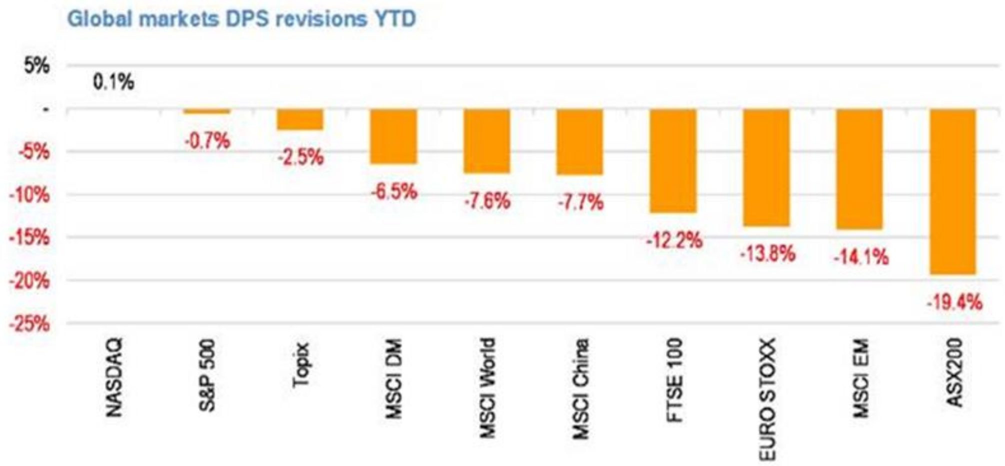
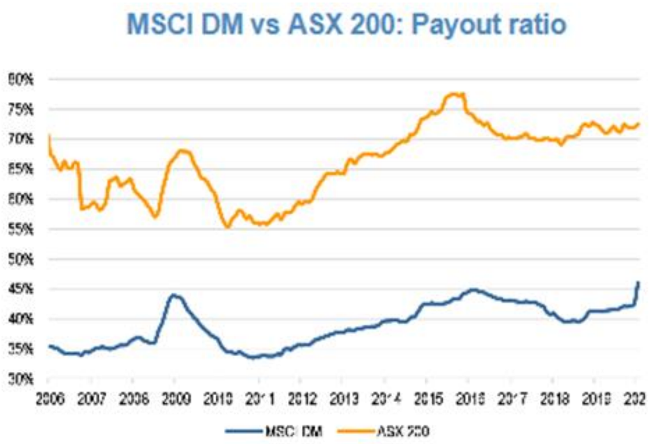
Australia's DPS revisions are stark when compared to other regional indices, as shown below.



Source: Bloomberg

Australia has much higher dividend yields and payout ratios vs MSCI DM

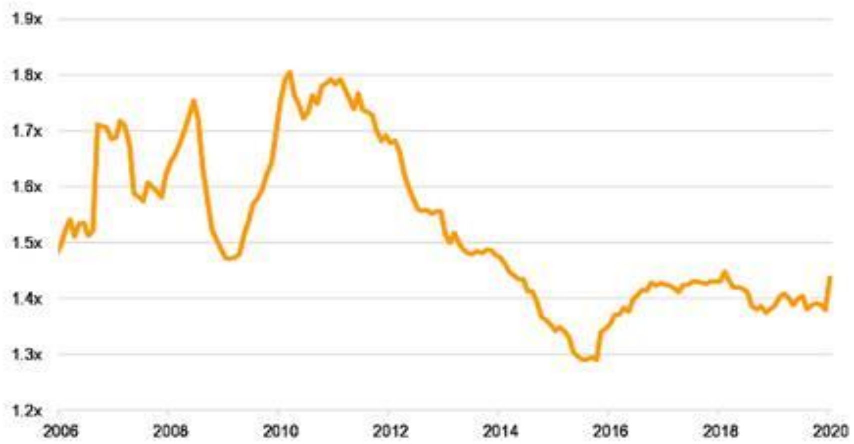
Source: Bloomberg.



Source: Bloomberg.

There are reasons for our high payout ratio. Most importantly, the dividend imputation system which results in franked dividends being a more tax effective way to distribute earnings than other forms of returns, such as on-market buybacks. By and large, Australia is on its own with this system so there is some structural reason for our higher payout ratio. However, Australia's higher payout ratio and lower dividend coverage leaves our dividend provision more vulnerable to economic shocks, especially in light of the COVID-19 crisis. With dividend cover for the ASX 200 at 1.45x, and likely to decline from here as company board conservatism retains higher levels of capital, the market yield status enjoyed by Australia is looking more precarious. It is imperative to focus on sustainable dollar dividend growth rather than optically high dividend yields that disappoint, as part of your stock selection criteria. This is a major focal point within our investment strategy.

Dividend cover has been falling



Source: Bloomberg

How far are we through the dividend cutting cycle?

When you compare current Australian dividend cuts to the GFC we are only about two thirds of the way through, as shown by the chart below provided below by JP Morgan. This means dividends can easily decline a further 10% or more from the circa 20% revisions we have already seen.

Source: J.P.Morgan estimates, Bloomberg

Portfolio activity levels were subdued in April after a higher than normal level of activity. We exited our position in Carsales.com over slowdown concerns in pricing and business activity in Australia and Brazil. We also exited our position in Dexus Property Group over structural concerns concerning the demand profile for commercial office space going forward and the level of rental relief that the group has been requested to provide to its tenants. Finally, we exited our position in GPT group given the expected pressure on earnings from declining tenant rental payments and retail property valuations going forward. These funds were deployed in large cap stocks with greater earnings and dividend certainty. We initiated a new position in Ramsay Healthcare via the participation of a $1.2 billion placement at $56.00 per share. The capital raising strengthens their balance sheet and allows them to undertake further brownfield capex which generates attractive ROIC outcomes. We also expect a normalisation in elective surgery rates as we come out of lock-down. The stock had been oversold on the elective surgery cancellation measures due to COVID-19. We also initiated a position during the month in Invocare for their more defensive earnings and dividend stream. Invocare operates funeral homes, cemeteries and crematoriums throughout Australia, New Zealand and Singapore. We entered the stock via participation in a $150 million capital raise at $10.40 per share. The company is set to complete its network upgrade program, thereby lifting utilisation rates, and make small bolt-on, value adding acquisitions going forward.

During the month we increased our exposure to the dividend champions yield category via participation in selective equity capital raisings. These were predominantly funded by selling down defensive property trust yields over concerns their distributions will be more adversely affected going forward than originally thought. Consequently, this resulted in a decreased exposure to defensive yield.

The beta of the Fund (a measure of volatility) continues to remain at a lower level as we remain concerned that the strong rebound we saw in April in many cyclical stocks will not be maintained given the continued deterioration in economic and company specific fundamentals. The beta of the portfolio is sitting comfortably at 0.85, below the market beta of 1.00. The expected FY 20 dividend growth rate of investee companies held within the portfolio is above that of the market, at -14.4% vs -26.9% for the ASX 200. Superior dividend growth rate to that of the market is a key part of our investment strategy. With around 80% of companies in our investment universe having suspended or cut dividends, the reasons for the decline are self-evident. In FY 21, we expect dividend growth to re-emerge, albeit from a lower base.

Regards,

Chris Hall - Portfolio Manager, CIO

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PORTFOLIO CHARACTERISTICS

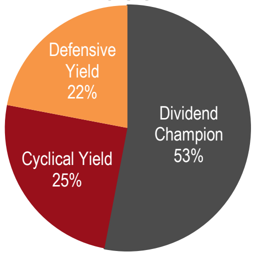
HOLDINGS

Top 10 holdings	Sector	%
CSL Limited	Health Care	9.44
Rio Tinto Limited	Materials	5.10
Westpac Banking Corporation	Financials	4.97
ASX Limited	Financials	4.92
Goodman Group	Real Estate	4.72
James Hardie Industries PLC	Materials	4.40
Spark New Zealand Limited	Communication Services	3.89
Ramsay Health Care Limited	Health Care	3.80
Resmed Inc	Health Care	3.67
Sonic Healthcare Limited	Health Care	3.37

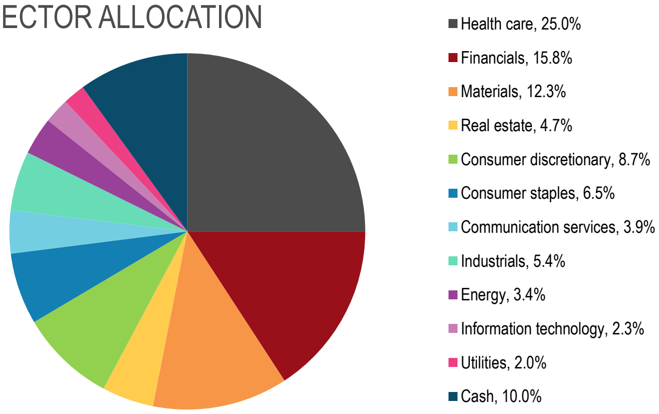
KEY PORTFOLIO METRICS

FY21(e)	Fund	Benchmark
Price/Earnings (x)	20.4	17.2
Dividend Yield (%)	3.2	3.9
Dividend Growth rate (%)	2.6	-2.2
Beta*	0.85	1.00

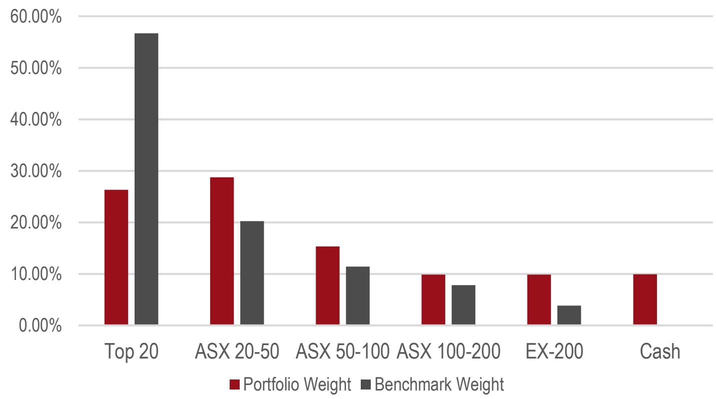
PORTFOLIO YIELD EXPOSURE



SECTOR ALLOCATION



MARKET CAPITALISATION



Source: Ellerston Capital

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

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