Ellerston Capital

Ellerston Australian Market Neutral Fund

Performance Report | May 20

PERFORMANCE SUMMARY

Performance	1 Month	3 Months	6 Months	1 Year	3 Year (p.a.)	5 Year (p.a.)	Since Inception (p.a.)
Net^	5.84%	-2.67%	-5.19%	11.90%	0.70%	2.52%	6.02%
Benchmark*	0.02%	0.08%	0.26%	0.74%	1.25%	1.45%	1.74%
Alpha	5.82%	-2.75%	-5.45%	11.16%	-0.55%	1.07%	4.28%

Source: Ellerston Capital

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

PORTFOLIO CHARACTERISTICS

KEY PORTFOLIO METRICS

Positive months	65%	**Net Equity Exposure**	24%
No. Relative Value positions	45	**Gross Portfolio Exposure**	198%
No. Special Situations	24	**Correlation Coefficient (vs ASX 200 Accum)**	53.36%
Beta Adjusted	7.6%	**Net Sharpe Ratio (RFR = RBA Cash)**	0.47

SECTOR ALLOCATION

Sector	Long Equity	Short Equity	Net Equity
Financials	36.7%	-26.2%	10.5%
Industrials	43.4%	-7.8%	35.6%
Resources	29.0%	-23.2%	5.7%
Index	1.7%	-30.0%	-28.3%
Total	**110.8%**	**-87.2%**	**23.6%**

Investment Objective

The Fund targets Absolute Returns with an annualised return objective of 5% above the RBA Cash Rate over rolling five year periods.

Investment Strategy

The Fund will seek to provide investors with a return profile that has low correlation with traditional asset classes. The Fund aims to generate positive returns in all market environment by reducing the majority of market risk and focusing on capital preservation and alpha generation. The Fund will utilise a Relative Value and a Special Situations strategy.

Key Information

Strategy Inception	3 June 2013
Portfolio Manager	Paul Drzewucki
Application Price	$1.0286
Net Asset Value	$1.0260
Redemption Price	$1.0234
Liquidity	Daily
Management Fee	1.20%
Performance Fee	20% of outperformance
Buy/Sell Spread	0.25%/0.25%

COMMENTARY

May was another strong month, with the Fund producing a net return of +5.84%, outperforming the benchmark return of +0.02% in the period. For the 2020 Financial Year to Date (11 months), the Fund has produced a return of +5.58% to investors, net of all fees. Net exposure was +23.6% at the end of May, with a beta-adjusted net of +7.6%. The number of opportunities continues to increase and our gross exposure moved higher accordingly, closing the period at 198%.

It was a diversified contribution within Relative Value in May, with no one position adding more than 65bps in the period. The largest contributor was a paired position between Peet (+22.4%) and Investec Australia Property (+14.3%), with Peet propelled higher by improving sentiment towards the residential property market. Despite the rally, Peet still closed the month at a 25% discount to NTA, with the funds management division (FY19 EBITDA of $24.4m), effectively given no value by the market.

The spread between Primewest Group (+18.8%) and Rural Funds (+3.1%) narrowed in the month, adding to the performance of the Fund. During May, Primewest announced the launch of its first Agricultural fund (Primewest Agricultural Trust No 1) as well as the purchase of the Osbourne Park headquarters of Seven West Media.

A newly-established position within the childcare REIT sector also added value, with both Charter Hall Social Infrastructure (+2.5%) and Arena REIT (+9.3%) trading higher in the month. The recently announced government stimulus packages have underpinned the viability of childcare operators, significantly increasing their ability to pay rent to their landlords (Charter Hall Social and Arena).

Our paired positon between intellectual property services firms QANTM Intellectual Property (-7.6%) and IPH Limited (+2.2%) detracted from performance with QANTM falling during the month, whilst IPH rallied.

The share price of Impedimed (+105.1%) rocketed higher in May, following the successful conclusion of their equity raise in April. The company also announced the appointment of a new Director – David Anderson, who currently serves as President and CEO of HealthNow Systems, which operates Blue Cross Blue Shield health plans in New York State.

We participated in the recapitalisation of Panoramic Resources (-2.2%), which added to the performance of the Fund. During the month, Panoramic raised $90m in an institutional placement and entitlement offer, after which rival nickel producer Western Areas (+4.6%) emerged with a 19.9% stake in the company. Proceeds of the recap will de-risk the restart of the Savannah Nickel Mine and fund project enhancement initiatives.

Our position in Village Roadshow (-9.3%) detracted from the performance of the Fund, despite receiving a revised takeover bid from private equity firm BGH in the period. The revised bid comprises a base offer price of $2.20 per share, an additional $0.08 per share if cinemas are reopened before the shareholder vote, and an additional $0.12 per share if theme parks are reopened. The previous bid from BGH that was tabled in January was a flat $4.00 per share.

Once again, the rising equity market caused the value of our index protection to fall, detracting value from the Fund.

ACTIVITY

Relative Value – Gross Contribution 3.98%

A paired position was established between building materials companies Fletcher Building (-3.2%) and Adbri (-0.4%). Fletcher Building had a horrible month, first with the announcement that its New Zealand-listed shares would be removed from the MSCI indices, and then downgrading FY20 earnings due to the COVID-19 lockdown. The company also was unable to provide guidance on FY21 earnings. At one point during the month, the company's shares traded down to book value – a level that hasn't been seen since 2008. We capitalised on the share price weakness, hedging the exposure with the outperforming Adbri.

We also added a number of new REIT pairs to the portfolio, including positions between Dexus (-1.7%) and the GPT Group (-5.7%), GDI Property (+3.8%) and Growthpoint Properties (+3.6%), Mirvac (+4.9%) and Stockland (+24.0%), and Scentre Group (-4.3%) and Vicinity Centres (+8.1%).

The spread between Spark Infrastructure (+11.6%) and AusNet Services (-3.8%) narrowed during the month, following the release of AusNet's FY20 result. The result was marginally ahead of consensus, but the company reduced its FY21 distribution by 7-12%, citing uncertainties caused by COVID-19, its investment pipeline, and impacts of upcoming regulatory resets. The resulting share price weakness led to the narrowing of the spread, and we consequently unwound our position.

Our exposure to the childcare centre REITs was increased in May, with the Fund adding to our long position in the Charter Hall Social Infrastructure REIT (+2.5%) at more than a 20% discount to NTA. We like the childcare sector, with the operators benefitting from JobKeeper on the cost side and the Early Childhood Education and Care Relief Package on the revenue side. We have hedged the position with Arena REIT (+9.3%), which trades at a modest premium to NTA.

Special Situations – Gross Contribution 1.97%

May was another busy month within Special Situations, with the Fund participating in a number of equity raises including Breville Group (+27.3%), Mesoblast (+19.0%), Panoramic Resources (-2.2%), Dicker Data (+12.7%), Technology One (-3.4%), Megaport (+14.6%) and Bigtincan Holdings (+0.0%). We also participated in two capital raises in New Zealand - SKY Network Television (-8.3%) and Z Energy (-9.0%).

Also during May, we established a position in Invex Therapeutics (+22.2%), following the release of the Phase II trial data for Exanatide. Exanatide is a small peptide, used in the treatment of type 2 diabetes but has been repurposed by Invex (and renamed Presendin) for the treatment of intracranial hypertension. The trial results were a success, with the results confirming the safety and potential of Exenatide to reduce intracranial pressure and with the trial data to be used in the design and execution of a single Phase III registration study. To fund the Phase III study, the company raised $26m in equity, with the new shares issued at a 13% discount to last.

We sold our remaining holdings in Credit Corp (+3.7%), Dacian Gold (+20.8%), Flight Centre (+19.0%), Infomedia (+2.2%), and continued to reduce our exposure to the Nufarm hybrids (-0.1%).

MARKET COMMENTRY

Market Overview

Global equity markets continued to rebound in May as investor confidence rose. Ongoing massive government stimulus and a progressive reopening of societies were expected to help economies and earnings recover quicker than was previously expected. All world developed markets rallied, with more cyclically exposed sectors like materials, IT and industrials outperforming. The Australian dollar was stronger, in part due to iron ore breaking through US$100/t. Oil also rebounded sharply on a better than expected demand outlook from the IEA, coupled with the expectation that OPEC+ would remain supply disciplined.

USA

In May, US stocks were buoyed by continued optimism around the reopening of the economy. The S&P 500 was up 4.8% (and astonishingly, has bounced 36% off its March lows), the Dow Jones was up 4.7% and the NASDAQ Composite was up 6.9%. As at the end of May, the NASDAQ was back in positive territory, up +6.2% for the calendar year-to-date!

May was a tricky month: geopolitically, tensions between the US and China flared up again and economically, services PMI indicated that the US services industry shrank for the first time in over a decade. The jobs report was also the worst on record (over 40m Americans out of work), with the unemployment rate surging to 14.7%. US activity indicators continued to be negative, with manufacturing ISM retracing to 41.5 (previous 49.1). By month's end and in early June, violent civil unrest and looting spread across a number of US cities, but markets pushed upward as investors bet on the number of COVID-19 infections continuing to fall, the prospect of a vaccine, and the economy rebounding as it reopened for business.

Europe

European equities also participated in the rally on hopes of an economic revival as coronavirus cases plateaued, economies commenced opening up again and the EU announced new stimulus measures for hard hit members. The Euro STOXX 50 closed the month up 4.7%. Among the major exchanges, the UK's FTSE 100 recorded a 3.3% gain, France's CAC 40 closed +3.4%, and Germany's DAX finished +6.7%.

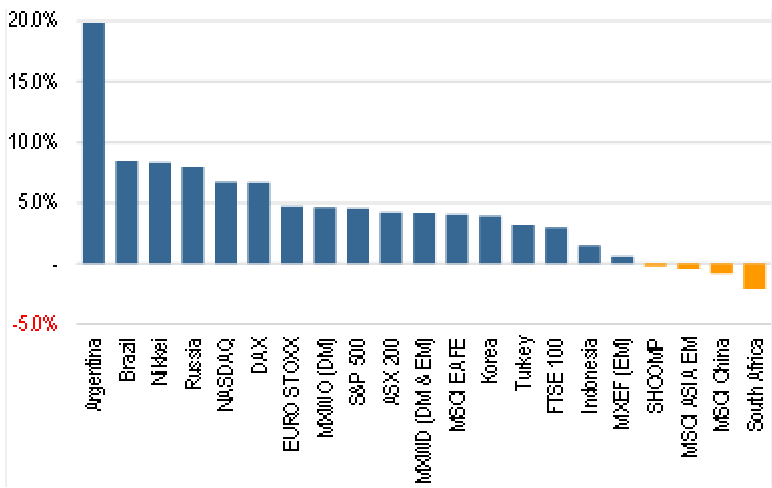
European activity indicators continued to be weak, but were better than expected. Surprisingly, the flash Eurozone manufacturing PMI for May was ahead of expectations at 39.5 (consensus: 38.0, previous: 33.4). Composite PMI also rose, but still to a woeful 30.5 (consensus: 27.0, previous: 13.6).

Asia

Asian equities were rather mixed, as some markets were hit by renewed tension between the US and China and new protests in Hong Kong that were in response to the Chinese government's proposed new laws likely to impact Hong Kong's domestic security. Against this backdrop, the Hang Seng index was hit hard and bucked the global trend, returning -6.3% in May. India's S&P BSE Sensex was down 3.7% as the cases of COVID-19 there continued to rise sharply. However, countries with more success in controlling the spread of COVID-19 like Japan and South Korea saw their equity markets rebound: Japan's Nikkei 225 was up 8.3% and Korea's KOSPI Composite was up 4.2%.

The Chinese market, as represented by the SSE Total Market Index was modestly down 0.6%. In the government work report released during the National People's Congress in late May, Beijing alluded to further stimulus, called for an extension of small business loans and vowed to create new monetary policy tools to support businesses. True to form, on 1st of June, the People's Bank of China (PBoC), together with the Ministry of Finance, announced two new credit easing measures to support bank lending to small businesses: RMB400 billion for purchasing qualifying credit loans directly from small banks, and another RMB40 billion for setting up a special purpose vehicle to help extend as much as RMB3.7 trillion in loans to small business. These two programs represented two new quantitative easing (QE) measures after the medium-term lending facility, through which the PBoC lends to large banks and pledged supplementary lending, through which the PBoC lends to policy banks. These two new QE-style programs should have the effect of increasing base money, should add to bank reserves and help small banks and small businesses survive.

Global equity markets performance in May 2020

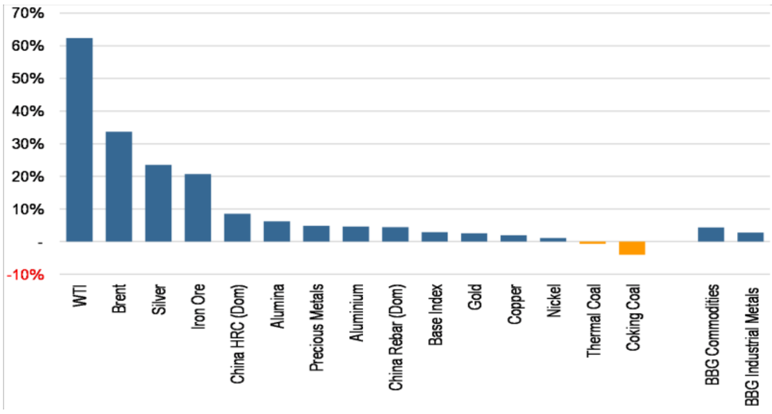


Source: JP Morgan, Bloomberg

Commodities

Global commodity markets staged a recovery in May. Brent oil ripped from a low base, in part driven by the improving global demand outlook and lower global supply, especially from OPEC+ and the US shale producers, with sharply lower rig counts. Iron Ore broke through the $100/t level for the first time in almost a year, driven by a combination of stronger Chinese steel demand and ongoing supply constraints in Brazil, where some mines were impacted by rising COVID-19 infections.

Global commodity performance in May 2020



Source: JP Morgan, Bloomberg

Bonds

Global bond yields remained low despite the rally in equity markets. 10-year yields in the US and in Australia were largely unchanged in May, with the former ending the month at 0.65% and the latter at 0.88%.

Australia

The S&P/ASX 200 Accumulation Index continued its strong upward trajectory, up another 4.4% in May. It is now down 12.7% calendar year to the end of May 2020.

The risk on mind set meant that the best performing sector during the month, in terms of its contribution to the index's performance, was Materials (for the second consecutive month), with a contribution of 1.6%. The next two best sectors were Financials (+1.2% contribution), and Real Estate (+0.5% contribution), with both playing catch-up in May. Not surprisingly, the more defensive segments of the market lagged again, with Health Care (-0.7% contribution, weighed down by CSL), Consumer Staples (-0.0% contribution) and Utilities (+0.1% contribution) being the bottom three sectors in terms of contribution to the market's performance.

The Small Ordinaries Accumulation Index was the best performing sub-sector, up 10.6%, followed by the ASX 200 Resources Accumulation Index, up 7.9%. The ASX 200 Industrial Accumulation Index underperformed the others with a return of 3.5%. The ASX 200 A-REIT sector continued its recovery and was up almost 7% in May.

The top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were: CSL (-98 points), Sydney Airport (-8 points), Incitec Pivot (-5 points), Alumina (-4 points) and Woolworths Group (-4 points).

The top five stocks that made a positive contribution to the index's return were BHP Group (+48 points), Goodman Group (+25 points), Afterpay (+25 points), Fortescue Metals Group (+24 points) and Wesfarmers (+21 points).

The RBA left rates unchanged in May and not unexpectedly, also left rates unchanged at 0.25% in early June. In its statement, the RBA commented on the nature and speed of the expected recovery being highly uncertain. It went on to say that the RBA Board was committed to do what it could 'to support jobs, incomes and businesses' and that this 'accommodative approach will be maintained as long as it is required'. There is an increasingly vocal debate on the merits or otherwise of negative interest rates. To date, the RBA governor has remained consistent in his opposition to negative rates, calling the move 'extraordinarily unlikely'. But these are extraordinary times!

The AU dollar continued to strengthen against the US dollar, supported by the rally in commodity prices, especially iron ore, and a widening interest rate differential to the US. It is was up 2.4% to finish the month at 0.667 and has recovered 20% from the mid-March low of 0.55!

CONTRIBUTION

Relative Value Gross Contribution 3.98%			
Positive		**Negative**	
INVESTEC AUSTRALIA PROPERTY - PEET	0.61%	IPH - QANTM INTELLECTUAL PROPERTY	-0.15%
BHP BILLITON - BHP BILLITON	0.57%	AGL ENERGY LTD - INFIGEN ENERGY	-0.13%
RIO TINTO - RIO TINTO	0.57%	APN INDUSTRIA REIT - ELANOR RETAIL PROPERTY FUND	-0.12%
ARENA REIT - CHARTER HALL EDUCATION TRUST	0.38%	BWP TRUST - CHARTER HALL RETAIL REIT	-0.09%
PRIMEWEST GROUP LTD - RURAL FUNDS GROUP	0.38%	CHARTER HALL RETAIL REIT - SHOPPING CENTRES AUSTRALASIA	-0.01%

Special Situations Gross Contribution 1.97%			
Positive		**Negative**	
IMPEDIMEDD LTD	1.38%	PUT SPREADS ON ASX 200	-1.20%
ELECTRO OPTIC SYSTEMS HOLDIN	0.76%	KALIUM LAKES LTD	-0.91%
IMRICOR MEDICAL SYSTEMS-CDI	0.31%	VILLAGE ROADSHOW LTD	-0.41%
PANORAMIC RESOURCES LTD	0.28%	LIMEADE INC-CDI	-0.32%
OPTICOMM LTD	0.23%	SUNCORP GROUP NOTE	-0.14%

Top 10 Relative Value Positions	
RIO TINTO - RIO TINTO	BWP TRUST - CHARTER HALL RETAIL REIT
BHP BILLITON - BHP BILLITON	GDI PROPERTY GROUP - GROWTHPOINT PROPERTIES
KAROON GAS AUSTRALIA LTD - SANTOS	APN INDUSTRIA REIT - GDI PROPERTY GROUP
AGL ENERGY LTD - INFIGEN ENERGY	CENTURIA INDUSTRIAL REIT - CROMWELL PROPERTY GROUP
ARENA REIT - CHARTER HALL EDUCATION TRUST	APN INDUSTRIA REIT - ELANOR RETAIL PROPERTY FUND

Top 10 Special Situation Positions	
PUT SPREAD ON ASX 200	UNITI WIRELESS LTD
NUFARM FINANCE NZ LTD-NSS	KALIUM LAKES LTD
LIMEADE INC-CDI	SUNCORP GROUP NOTE
VILLAGE ROADSHOW LTD	IMPEDIMEDD LTD
VOLPARA HEALTH TECHNOLOGIESS	ATOMOS LTD

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 7797 or info@ellerstoncapital.com

or visit us at https://ellerstoncapital.com/

SYDNEY OFFICE

Level 11, 179 Elizabeth Street,
Sydney NSW 2000

MELBOURNE OFFICE

Level 4, 75-77 Flinders Lane,
Melbourne VIC, 3000