

Ellerston Australian Market Neutral Fund

Performance Report | July 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 ^a	5.96%	14.71%	-0.21%	13.36%	3.02%	3.77%	7.07%
Benchmark*	0.02%	0.06%	0.18%	0.59%	1.18%	1.39%	1.71%
Alpha	5.94%	14.65%	-0.38%	12.76%	1.84%	2.38%	5.37%

Source: Ellerston Capital

^aNet 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	66%	Net Equity Exposure	25%
No. Relative Value positions	49	Gross Portfolio Exposure	248.5%
No. Special Situations	24	Correlation Coefficient (vs ASX 200 Accum)	52.16%
Beta Adjusted	22%	Net Sharpe Ratio (RFR = RBA Cash)	0.58

SECTOR ALLOCATION

Sector	Long Equity	Short Equity	Net Equity
Financials	36.0%	-17.8%	18.1%
Industrials	55.2%	-12.2%	42.9%
Resources	30.9%	-23.2%	7.7%
Index	9.9%	-53.9%	-44.1%
Total	131.9%	-107.3%	24.6%

COMMENTARY

The Fund produced a net return of +6.0% in July, outperforming the benchmark return of +0.0% in the period. Net exposure was +25.0% at the end of July, with a beta-adjusted net of +22.0%. The opportunity set remains at elevated levels and gross exposure moved higher accordingly, closing the period at +248.5%.

As we had hoped, Karoon Energy (+18.2%) announced revised Bauna transaction details during July, with the new deal allowing Karoon to proceed with the acquisition without the need for debt. The revised transaction is broken into two parts: 1) US\$380m consisting of US\$150m on settlement and the balance in 18 months and 2) US\$285m in instalment payments, contingent on the oil price averaging over US\$50 per barrel over the period 2022 to 2026. The deal is expected to close in the current quarter, with a number of regulatory approvals still to be granted. The stock responded positively to the announcement, outperforming Santos (-0.6%), which closed marginally lower.

Our paired position between telecommunication companies Uniti Group (+9.2%) and TPG Telecom (-9.7%) also added value in the month, with Uniti trading higher following their equity raise in June. Recall that in June, Uniti announced the proposed acquisition of rival telco Opticomm (+2.0%), with the cash-and-scrip deal receiving the approval of the Opticomm board and major shareholders. The deal is expected to close in September and is 23% EPS accretive, after synergies.

A narrowing in the spread between Adbri (-30.5%) and Fletcher Building (-9.3%) added to performance, after Adbri announced that Alcoa of Australia had elected not to renew its lime supply contract (approximately \$70m in revenue). The announcement shocked the market as Alcoa has sourced lime from Adbri for almost 50 uninterrupted years. The market's surprise was best illustrated in the share price reaction, with Adbri falling over 25% on the day.

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	\$1.0189
Net Asset Value	\$1.0164
Redemption Price	\$1.0139
Liquidity	Daily
Management Fee	1.20%
Performance Fee	20% of outperformance
Buy/Sell Spread	0.25%/0.25%

The spread between the Australian and UK listings of both BHP Group (+2.6%) and Rio Tinto (+4.1%) widened during the period, detracting from the performance of the Fund.

Once again, our long position in Damstra Holdings (+29.8%) added value, with the company announcing the acquisition of Vault Intelligence (+73.3%) during the month. The acquisition will be by way of a Scheme of Arrangement, where Vault shareholders will receive 1 share in Damstra for every 2.9 Vault shares they hold. Damstra also announced an upgrade to FY20 earnings, with the stock moving higher following the news.

Imricor Medical Systems (+24.2%) also moved higher in the month, following an announcement that the company had signed a non-exclusive sales distribution agreement with Philips Electronics. Amongst other things, Philips is a worldwide leading manufacturer of MRI equipment and hence is well positioned to sell the Imricor device.

The performance of our other healthcare investments was mixed. Impedimed (+21.0%) added value following the release of their June quarter results, but Invex Therapeutics (-27.7%) traded lower after reporting the initial FDA and EMA advice on the development of Presendin, their treatment for idiopathic intracranial hypertension.

ACTIVITY

Relative Value – Gross Contribution 4.54%

We established a paired position between Insurance Australia Group (-11.8%) and Suncorp (-7.4%), following an announcement from Insurance Australia that their FY20 earnings would be significantly lower than market expectations. There were multiple reasons behind the downgrade, including reserve strengthening in 2H20, additional customer refund provisions, softer underlying margins and higher perils. The share price of Insurance Australia suffered a dramatic fall, before closing modestly higher at the end of the month.

A paired position within supermarkets was also introduced during July, with the Fund buying the underperforming Woolworths (+3.8%) and hedging the exposure with Coles (+5.8%). Whilst both companies have been beneficiaries of the COVID-19 environment, Woolworths has underperformed its smaller peer, leading to an unexplained widening in the spread.

We capitalised on a liquidity event in the newly-renamed Waypoint REIT (-2.7%), acquiring a shareholding in the service station owner in a block sale at a modest discount to last. The vendor of the shares was Charter Hall, who is rumoured to be buying a minority interest in the Ampol (-10.4%) network of stations. Our Waypoint position was hedged with Charter Hall Long Wale REIT (+8.2%), which has a stake in the BP network of service stations.

We unwound our paired positions between Fletcher Building and Adbri, Afterpay (+12.4%) and Sezzle (+81.4%), Aventus (+0.5%) and Home Consortium (-0.3%), and Nine Entertainment (-1.8%) and Domain Holdings (-1.5%), following a narrowing in their respective spreads.

Special Situations – Gross Contribution 1.54%

It was a relatively quiet month within Special Situations, ahead of the semi-annual earnings season in August. With Vault Intelligence trading at almost a 15% discount to the implied bid price, we switched some of our Damstra exposure into Vault, maintaining a similar exposure to the group. We also added to our exposure in Opticomm, which was trading 5% below the implied bid price at the time.

Our exposure to Atomos (+11.8%) was increased during July, with the stock struggling to stay above the issue price of May's equity raise. At the end of the month, the company provided a trading update, which indicated a strong bounce in July revenue and confirmed the reduced cost base. Atomos remains one of our most-high conviction ideas, with the company poised to release a number of new products that should further strengthen their market position.

After exiting Village Roadshow (+1.4%) in June, we re-established a shareholding in July, with increased confidence that the private equity bid would be formalised. The trading environment for Village is slowly improving, with Village's Gold Coast theme parks reopening in late June, albeit at 50% capacity. Cinemas around the country have also reopened, although those in Melbourne have recently been closed again. The stock trades on an FY21 EV/EBITDA multiple of <10x, with earnings expected to remain subdued until at least FY22.

We reduced our exposure to Kalium Lakes (+0.0%), Limeade (+3.1%), Orthocell (+9.5%), and completely exited our position in uranium company Paladin Energy (+25.0%), following a jump in its share price. We also modestly reduced our exposure in the Nufarm hybrid securities (+3.2%).

MARKET COMMENTRY

Market Overview

In July, there was a continued sharp rise in global COVID-19 cases as restrictions on mobility were eased around the world. Despite this, global equities recorded another solid rise. The Australian market lagged many of the major indices as sentiment turned negative following the spike in cases in Victoria. Investor sentiment remains fragile despite some tentative signs of an uptick in manufacturing. Regulators continue to maintain an accommodative stance with bond yields continuing to decline and the bullion price keeps rising, touching a record high. Markets are looking to the upcoming reporting season for guidance on the financial health of companies.

USA

In July, US equity markets squeezed higher despite rising numbers of COVID-19 cases. Hopes of a vaccine and better than expected results from companies at the start of the US reporting season, helped support the market. Debate among US legislators continues on whether to extend unemployment benefits. At the time of writing, a deal to extend unemployment benefits remains elusive, and COVID-19 deaths in the U.S. (especially the South and West) continue to surge. While 5 million jobs were created in June, further advances are likely to slow. A similar pattern is evident in weekly claims, which has flattened in recent weeks.

78% of S&P 500 stocks by market cap have reported 2Q results. While earnings are on target for a -35% year-on-year contraction, companies have topped expectations by 23%, the largest surprise on record. Over the past year, the 5 largest S&P 500 companies (Apple, Microsoft, Amazon, Alphabet and Facebook) returned 58% versus 1% for the rest of the market, driven predominantly by superior top line growth and earnings. 2Q EPS for the Big 5 grew 19% versus -40% for the rest of the market.

For the month, the S&P 500 was up +5.6%, the Dow Jones was up +2.5% and the NASDAQ Composite was up an impressive +6.9%. The NASDAQ has delivered a stellar return of +20.4% for the calendar year to date.

Activity indicators from June showed positive signs: the manufacturing ISM rose to 52.6, slightly better than expectations, and non-farm payrolls rose by +4800K in June (consensus: +3230K; previous: +2509K), with the unemployment rate falling to 11.1% from 13.3% previously.

Europe

European equities started the month strongly on optimism over better US jobs data and a surprise beat on the German PMI. The initial rally soon faded as policy makers disagreed on the structure of the next stage of the stimulus.

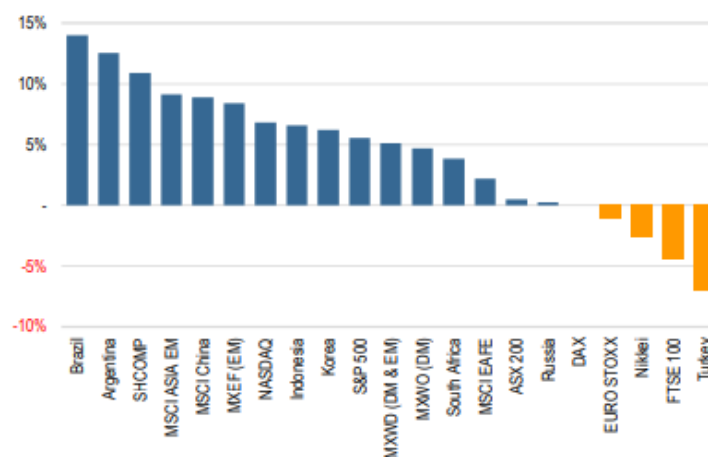
The Euro STOXX 50 Index closed the month down 1.6%. Among the major exchanges, the UK's FTSE 100 was the hardest hit, 4.2%, France's CAC 40 was down 2.6%, and Germany's DAX ended the month flat.

European equities sold off despite activity indicators improving ahead of expectations. Flash Eurozone manufacturing PMI for June was higher, up to (a still weak) 47.4 (previous: 39.4) and the composite PMI rose to 48.5 (previous: 31.9).

Asia

Asian equities were broadly stronger as positive vaccine news and a better than expected Chinese GDP print supported markets. The Hang Seng Composite Index returned +1.5%, the Chinese SSE Composite Index was up a massive 12.8%, but Japan's Nikkei 225 Index bucked the trend and closed down 2.6%. Chinese economic data showed some improvement, with the June trade surplus ahead of expectations and importantly, the June manufacturing PMI moved up to 51.2 (consensus: 50.5, previous: 50.7).

Global markets performance in July 2020

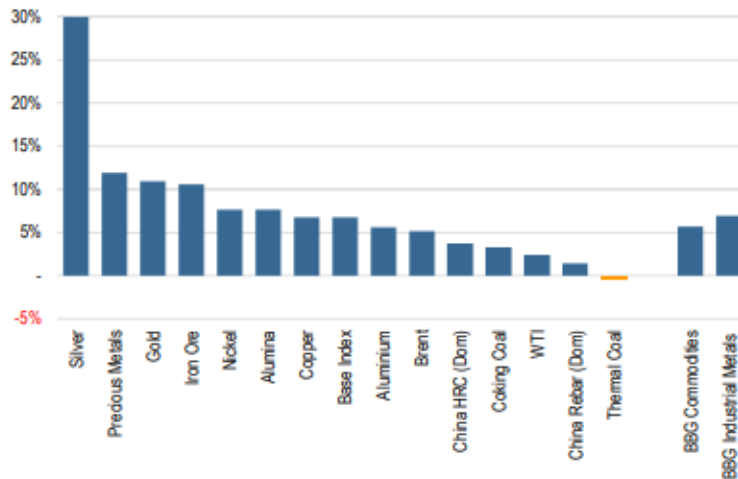


Source: JP Morgan, Bloomberg

Commodities

Global commodity markets continued to rise in July. Brent Oil prices rose to US\$43.62 a barrel, driven in part by the expectations of an improving economic outlook and the fall in the US dollar. Iron Ore prices continued to climb and ended the month at US\$111 a tonne. Gold was a highlight, hovering around record highs at US\$1986/oz, as real yields in the US remained negative. However, the star performer was Silver, up 30% to US\$24.22/oz, finally playing catch up with the rest of the precious metals suite.

Global commodity performance in July 2020



Source: JP Morgan, Bloomberg

Bonds

Global bond yields continued their decline in July. The US 10-year government bond yield fell another 10 basis points to 0.55%, while the Australian 10-year government bond yield fell another 5 basis points to 0.82%.

Australia

The S&P/ASX 200 Accumulation Index commenced the new financial year marginally in the black, with a return of +0.5% in July. This was the fourth consecutive month of gains. The outbreak in Victoria and small pockets of COVID-19 in other states had investors on edge, especially towards month end.

The Materials sector was the best performer (led by Fortescue Metals), in terms of contribution to the index's performance, with a contribution of +1.1%. Consumer Staples (+0.2%) and Consumer Discretionary (+0.2%) were the next two best sectors, in terms of contribution to the Index. Conversely, the bottom three sectors, were Health Care (-0.5%), Financials (-0.3%) and Industrials (-0.3%).

The ASX 200 Resources Accumulation Index was the best performing sub-index, returning +4.3%, with commodities strongly bid up in anticipation of improving global growth. The Small Ordinaries Accumulation Index had a good month too, returning +1.4% while the ASX 200 Industrial Accumulation Index was the worst performer with a return of -0.5%.

The top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were: CSL (-46 points), followed by three of the big four major banks; Westpac Banking Corporation (-18 points), Australia and New Zealand Banking Group (-11 points) and National Australia Bank (-11 points) as investors were troubled by likely top-ups to provisions for loan losses and the likelihood of much lower dividends. The fifth was Insurance Australia Group which issued a surprise profit warning (-9 points).

The top five stocks that made a positive contribution to the index's return were Fortescue Metals Group, spurred on by the strong rise in Iron Ore prices (+36 points), Goodman Group (+20 points), Commonwealth Bank of Australia (+19 points), with investors expecting it to pay a bigger dividend relative to its peers, Newcrest Mining (+18 points) as the price of Gold kept rising and BHP Group (+17 points), another beneficiary from the strength in commodity prices.

The RBA left rates unchanged in July. The Australian dollar had a strong month – its third best quarter since 2000. It gained 3.5% against the US dollar and broke through 70 US cents in mid-July, finishing the month at 71.4 US cents.

CONTRIBUTION

Relative Value Gross Contribution 4.54%

Positive		Negative	
KAROON GAS AUSTRALIA LTD – SANTOS	1.67%	CARINDALE PROPERTY TRUST - INGENIA COMMUNITIES GROUP	-0.40%
TPG TELECOM LTD - UNITY WIRELESS LTD	1.13%	APN INDUSTRIA REIT - ELANOR RETAIL PROPERTY FUND	-0.35%
AROA BIOSURGERY LTD - POLYNOVO LTD	0.90%	APN INDUSTRIA REIT - GDI PROPERTY GROUP	-0.24%
ADELAIDE BRIGHTON - FLETCHER BUILDING	0.45%	CENTURIA INDUSTRIAL REIT	-0.21%
AFTERPAY TOUCH GROUP LTD - SEZZLE INC	0.41%	CORPORATE TRAVEL MANAGEMENT - WEBJET	-0.11%

Special Situations Gross Contribution 1.54%

Positive		Negative	
IMPEDIMEDD LTD D	0.46%	INVEX THERAPEUTICS LLTD	-0.87%
DAMSTRA HOLDINGS LTD	0.44%	PANORAMIC RESOURCES LTD	-0.19%
IMRICOR MEDICAL SYSTEMS	0.38%	SKY NETWORK TELEVISION LTD	-0.10%
PALADIN ENERGY LIMITED	0.38%	US MASTERS RESIDENTIAL PROPE	-0.09%
ATOMOS LTD	0.34%	SUNCORP GROUP NOTE	-0.08%

Top 10 Relative Value Positions

RIO TINTO - RIO TINTO	COLES GROUP LTD - WOOLWORTHS
BHP BILLITON - BHP BILLITON	COMMONWEALTH BANK OF AUSTRALIA - WESTPAC BANKING CORP
KAROON GAS AUSTRALIA LTD - SANTOS	CROMWELL PROPERTY GROUP - CHARTER HALL EDUCATION TRUST
MIRVAC GROUP - STOCKLAND	BORAL - FLETCHER BUILDING
TPG TELECOM LTD - UNITY WIRELESS LTD	APN INDUSTRIA REIT - ELANOR RETAIL PROPERTY FUND

Top 10 Special Situation Positions

PUT SPREAD ON ASX 200	LIMEADE INC
OPTICOMM LTD	SUNCORP GROUP NOTE
NUFARM FINANCE NZ LTD	IMPEDIMEDD LTD D
VOLPARA HEALTH TECHNOLOGIESS	INVEX THERAPEUTICS LLTD
ATOMOS LTD	VILLAGE ROADSHOW LTD

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

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