

# Ellerston Australian Market Neutral Fund

Performance Report | September 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 <sup>A</sup>	3.39%	10.04%	29.25%	11.85%	3.98%	4.14%	7.46%
Benchmark <sup>*</sup>	0.02%	0.06%	0.12%	0.47%	1.11%	1.33%	1.67%
Alpha	3.37%	9.98%	29.13%	11.38%	2.87%	2.81%	5.79%

Source: Ellerston Capital

<sup>A</sup>Net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance

<sup>\*</sup>RBA Cash Rate

## PORTFOLIO CHARACTERISTICS

### KEY PORTFOLIO METRICS

Positive months	67%	Net Equity Exposure	22%
No. Relative Value positions	52	Gross Portfolio Exposure	193.0%
No. Special Situations	21	Correlation Coefficient (vs ASX 200 Accum)	50.09%
Beta Adjusted	30.7%	Net Sharpe Ratio (RFR = RBA Cash)	0.63

## SECTOR ALLOCATION

Sector	Long Equity	Short Equity	Net Equity
Financials	35.8%	-25.8%	10.0%
Industrials	41.4%	-4.2%	37.2%
Resources	26.1%	-18.3%	7.9%
Index	0.0%	-33.4%	-33.4%
<b>Total</b>	<b>103.3%</b>	<b>-81.7%</b>	<b>21.7%</b>

## COMMENTARY

The Fund produced a net return of +3.39% in September, significantly outperforming the benchmark return of +0.02%. The S&P/ASX 200 accumulation index returned -3.66% during the period. Net exposure was +22% at the end of September, with a beta-adjusted net of +30.7%. We continued to harvest a number of Relative Value positions during the month and gross exposure reduced by almost 40%, closing the period at 193.0%.

Once again, the paired position between Karoon Energy (-2.5%) and Santos Energy (-13.9%) added to performance, with Karoon edging ever closer to settlement of the Bauna oilfield acquisition. During September, the company announced the appointment of Peter Botten as Non-Executive Director (NED), effective from 1 October. Botten is the former CEO of Oil Search, where he grew the market capitalisation of the company from \$200m to a peak of over \$15b. Most importantly, Botten is fiercely independent – an essential requirement if the company is to improve corporate governance. As at the end of August, only two conditions to the Bauna transaction remain, being ANP approval and FPSO charter assignment, both of which we now expect will be satisfied by the end of October.

It was a busy month for Uniti Group (+1.4%), with the diversified telco forced to fend off an 11<sup>th</sup> hour rival bid for OptiComm (+17.5%). Only days before the Scheme meeting was scheduled, OptiComm received an unsolicited all-cash bid from the First State Superannuation Scheme, at a significant premium to the Uniti bid price. Uniti was forced to match the new price and acquired an economic interest in 19.4% of the outstanding shares in OptiComm, to deter any bidders from getting involved. Despite Uniti trading lower in the month, the paired position which was hedged with TPG Telecom (-11.3%) added to performance.

We participated in the IOOF (-25.3%) placement in September, with the stock trading lower following the capital raise announced in August. IOOF raised a total of \$1.04b to fund the \$1.44b acquisition of MLC, comprising its financial advice, platforms and asset management businesses. While the market broadly likes the acquisition fundamentals, the integration risks are large and the acquisition will take time to digest. Our position in IOOF detracted from the performance of the Fund.

### 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	\$1.0581
Net Asset Value	\$1.0555
Redemption Price	\$1.0529
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 Rio Tinto (-3.8%) continued to narrow in September, adding to the performance of the Fund.

The share price of Atomos (+23.8%) rallied in September, adding to the value of the Fund. The video technology company specialises in monitor-recorded content and is a direct beneficiary of the “reopening” of society, following COVID-19 restrictions. Our long position in OptiComm also added value in the period, following the previously mentioned approach from the First State Superannuation Scheme.

We had mixed results from our healthcare positions, with Imricor Medical Systems (+62.0%) doing well but Volpara Health Technologies (-5.4%) and Osteopore (-8.5%) trading lower. Imricor announced a series of purchase agreements during September, including the Maastricht University Centre, Leipzig Heart Centre and the Rhon Clinic Bad Neustadt Campus. The company also announced it had been awarded a contract from the US National Institutes of Health to develop an MRI compatible myocardial biopsy system.

The weaker equity market in September led to the derivative position adding to the Fund's value.

## ACTIVITY

### Relative Value – Gross Contribution 1.13%

It was an incredibly busy month for Relative Value in September, with the Fund active in a wide range of sectors.

The spread between Fletcher Building (+9.2%) and Boral (+13.7%) narrowed early in the month, before widening late in the period. Seven Group Holdings (-4.9%) continued to add to their shareholding in Boral and late in the month were granted two board seats. Unless there is a bid coming, Seven Group is now at capacity in Boral, so the stock is likely to trade on fundamentals in the near term. We still believe consensus FY21 earnings for Fletcher Building is too low and expect an upgrade at next month's AGM.

The majority shareholder in Abacus Property (+4.7%) used the “creep provision” to increase their stake by 1.3% in September, purchasing the shares at a modest premium to market. We capitalised on the liquidity, setting up paired positions between Abacus and National Storage (-4.5%) and Abacus and The GPT Group (+1.8%). We also unwound a paired position between Abacus and the Charter Hall Long Wale REIT (+2.8%) in the month.

A new pair within the banks was established, with a long in ANZ Banking Group (-5.8%) hedged with a short in National Australia Bank (-1.0%). During the month, the federal government announced the relaxation of responsible lending rules, which led to an immediate jump in the share price of all the Australian banks, including ANZ and National Australia. In terms of valuation though, ANZ is cheaper, trading at just 0.79x book value compared with National Australia at 0.94x book.

We unwound paired positions between Helloworld Travel (-7.2%) and Corporate Travel Management (+10.9%), Capitol Health (-4.0%) and Integral Diagnostics (-6.3%), Aroa Biosurgery (+3.1%) and PolyNovo (0.0%), and SKYCITY Entertainment (+21.1%) and Tabcorp Holdings (-7.7%). We also reduced our exposure to our long-term pair between childcare landlords Arena REIT (+7.2%) and the Charter Hall Social Infrastructure REIT (+5.0%).

### Special Situations – Gross Contribution 3.21%

October is Breast Cancer Awareness Month and we expect a jump in the news flow for Volpara Health Technologies (-5.4%) during the period. Volpara is a NZ-based medical technology company with a product that provides feedback on breast density, compression and image quality. Its enterprise-wide practice software also improves productivity, compliance, reimbursement and patient tracking. During the month, we expect to get an update on the digital marketing initiative (announced in August), a summary of September quarterly sales, and news from the US FDA on new steps to modernise breast cancer screening (including the mandatory reporting of breast density to patients). Ahead of what should be a busy month, we added to our holding at about the same price as where shares were issued at the equity raise in April.

We participated in the Initial Public Offering of Access Innovation (-6.5%) in September, with the company's share price trading lower on debut. Access Innovation is a provider of live and recorded captioning, transcription and translation services and has experienced strong growth over the past five years. Its technology platform combines artificial intelligence and human expertise to deliver a higher level of speech-to-text accuracy than peers. We like management and the technology and believe growth expectations are conservative, particularly with the increasing use of video conferencing.

After adding to our exposure in OptiComm last month, we sold our entire position in September, following the announcement that a competing proposal for OptiComm had been received from the First State Superannuation Scheme. The new proposal was pitched at a 12.5% premium to the Unifi bid, and was presented as a cash offer for all outstanding shares. We reinvested part of the OptiComm proceeds into Unifi, which sits within a Relative Value pair and is hedged with TPG Telecom.

We reduced our exposure to Atomos (+23.8%), Imricor Medical Systems (+62.0%) and Limeade (-2.0%) in September and completely exited our positions in Cann Group (+5.0%), Panoramic Resources (+32.9%) and SKY Network Television (+4.0%).

## MARKET COMMENTRY

### Market Overview

In September, global equities retreated with the more cyclical sectors namely, Energy, Financials and Communication Services dragging markets lower. An alarming rise in the cases of COVID-19 around the world, event risk from an uncertain US election outcome and a hard Brexit, plus likely slower global growth weighed on investor sentiment. Gold was also weaker despite a “risk-off” mood. The US dollar was stronger, with a weaker iron ore price pushing the Australian dollar lower. Bond yields were largely flat and an easing of inflation expectations saw real yields rise modestly.

### USA

US markets took a breather from their record breaking run, recording negative returns. Rising COVID-19 cases and fears that the recovery had stalled put a lid on investor enthusiasm. Not surprisingly, the Federal Reserve left interest rates at near zero and signalled that it would hold rates there until at least 2023 to help the US economic recovery. The Fed also stated that it “expects to maintain an accommodative stance of monetary policy” until it achieves inflation averaging 2 per cent over time. However, politicians in Washington failed to agree on the size and timing of another stimulus package.

The NASDAQ Composite finished the month in negative territory with a return of -5.1%, but the index still remains up an impressive 25.3% for the calendar year to date. The S&P 500 was down 3.8%, led by a pullback in large cap tech names, with Apple recording its biggest one-day drop since March 16th and the Dow Jones posted a -2.2% return. Even a solid August jobs report, where the unemployment rate dropped to 8.4%, versus consensus of a 9.8% print failed to stem the sell-off.

Activity indicators were mixed. The manufacturing ISM lifted to 56.0 (consensus: 54.8, previous: 54.2) but the composite non-manufacturing ISM was slightly below expectations, falling to 56.9 (consensus: 57.0; previous: 58.1).

### Europe

European markets were not spared in the global sell-off, impacted by similar issues to those facing the US market. Additionally, the spike in COVID-19 cases was particularly pronounced in key European countries such as Spain and Italy, leading to fears of a second lock-down, resulting in a downgrade of growth expectations.

The Euro STOXX 5.0 Index closed the month down 2.3%. Among the major exchanges, Germany’s DAX’s returned -1.4%, France’s CAC 40, -2.7%, and the UK’s FTSE 100, -1.5%.

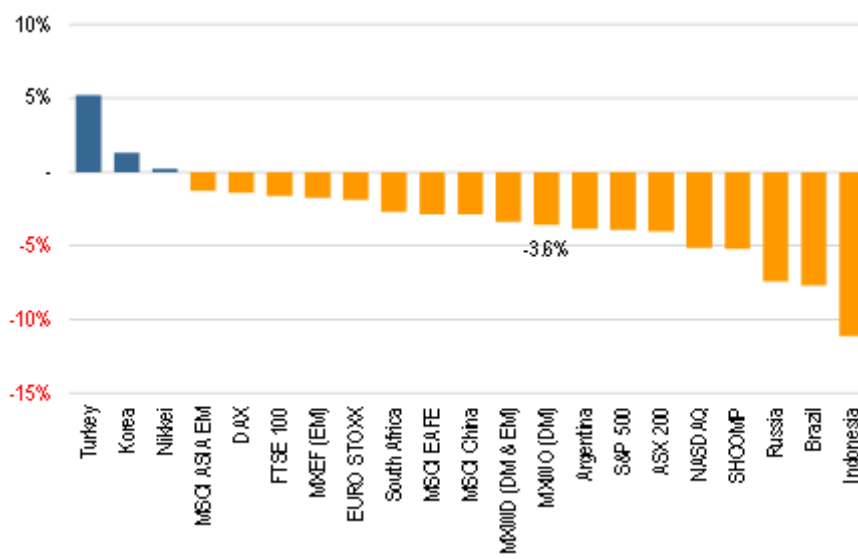
Activity indicators in Europe were again mixed. The flash Eurozone manufacturing PMI for August rose to 53.7 (consensus: 51.9, previous: 51.7), but the composite PMI fell to 51.9 from 54.9.

### Asia

Fears of global growth tapering off severely impacted certain Asian markets in September. The Hang Seng Composite Index returned -6.4%, the Chinese SSE Composite Index was down 4.8%, but Japan’s Nikkei 225 Index bucked the trend on better than expected dividends and closed up 2.2%.

Despite concerns over global growth, September PMIs and August trade reports suggest a further broadening of the economic recovery in China. Manufacturing PMI for September beat expectations rising 0.5 points to 51.5 and non-manufacturing PMI registered a further gain of 0.7 points to 55.9. Export activity, up 1.3%, was also stronger.

Global markets performance in September 2020

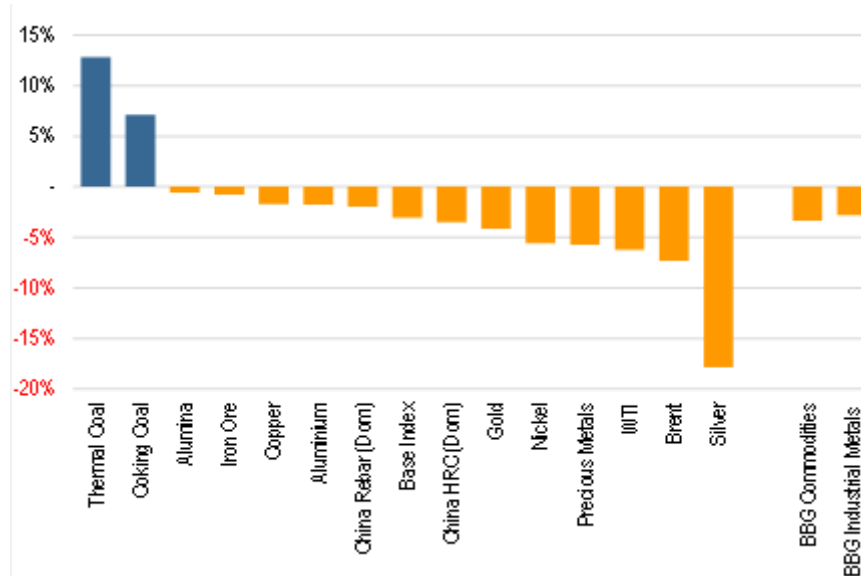


Source: JP Morgan, Bloomberg

## Commodities

Commodity prices fell in September as global growth expectations declined. Brent Oil fell 8% to \$42/bbl. Iron Ore declined to \$123/t, as Chinese iron ore inventories rose in line with supply increases. Gold prices decreased again, falling 4% to \$1,887/oz on the back of a stronger US dollar and higher real interest rates. Coal prices were the only outlier for the month and squeezed higher from recently bombed out levels as supply cuts by marginal producers were starting to impact.

Global commodity performance in September 2020



Source: JP Morgan, Bloomberg

## Bonds

Global bond yields were also lower in September, with the US 10-year treasury yields retracing 2 basis points to 0.68%. However inflation expectations fell on lower growth expectations and a lower oil price. The Australian 10-year government bond yields also fell 19 basis points to 0.79% as the market increasingly expected the RBA to cut official rates to 10 basis points following a dovish speech by the RBA's Guy Debelle.

## Australia

The S&P/ASX 200 Accumulation Index was down -3.7% for the month, breaking its 5-month run of positive returns. The Australian market was impacted by concerns over slowing global growth and an uncertain US election outcome.

The Health Care sector was the stand out performer in terms of contribution to the index's performance, with a contribution of +0.1%. No other sector delivered a positive return in the month. The second best performing sector was Industrials (with a contribution of -0.0%), followed by Utilities (-0.1%). The bottom three sectors, were Financials (-1.6%), Materials (-0.6%) and Energy (-0.4%).

The Small Ordinaries Accumulation Index was the best performing sub-index, with a return of -2.8%, followed by the ASX 200 Industrial Accumulation Index, returning -3.2% and the ASX 200 Resources Accumulation Index, -5.3%.

The top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were: Commonwealth Bank of Australia (-50 points), BHP Group (-27 points), Woolworths Group (-22 points), Wesfarmers (-21 points) and Australia and New Zealand Banking Group (-18 points).

The top five stocks that made a positive contribution to the index's return were Transurban Group (+10 points), CSL (+8 points), James Hardie Industries (+6 points), Aristocrat Leisure (+6 points) and Sonic Healthcare (+5 points).

On September 25, the Morrison Government announced their intention to repeal responsible lending obligations from March 2021 except for credit contracts and consumer leases. This would replace the current practice of 'lender beware' with a 'borrower responsibility' principle. Bank shares rallied on the news, led by Westpac (+7.4%), NAB (+6.9%), ANZ (+6.3%) and CBA (+3.0%).

Towards month end, restrictions in Melbourne were loosened. Night time curfews were removed, while children began a staged return to schools. Allowable exercise time was also increased from one to two hours per day. COVID 19 cases continued to decline in Australia, with an average of 41 local transmitted cases per day through September (down from 283 local cases per day on average in August).

In economic news, the RBA left rates unchanged, 2Q GDP slumped by a record 7.0% quarter-on-quarter and the Australian dollar ended the month lower at 0.72 US cents.

## CONTRIBUTION

### Relative Value Gross Contribution 1.13%

Positive		Negative	
KAROON GAS AUSTRALIA LTD - SANTOS	0.49%	IOOF – IOOF CALL OPTION	-1.06%
TPG TELECOM LTD - UNITI WIRELESS LTD	0.44%	APN INDUSTRIA REIT - GDI PROPERTY GROUP	-0.26%
RIO TINTO - RIO TINTO	0.34%	IOOF HOLDINGS LTD - MACQUARIE GROUP LTD	-0.20%
CARINDALE PROPERTY TRUST - CHARTER HALL LONG WALE REIT	0.29%	APN INDUSTRIA REIT - ELANOR RETAIL PROPERTY FUND	-0.18%
BHP BILLITON - BHP BILLITON	0.25%	CARINDALE PROPERTY TRUST - INGENIA COMMUNITIES GROUP	-0.10%

### Special Situations Gross Contribution 3.21%

Positive		Negative	
PUT SPREAD ON ASX 200	1.47%	VOLPARA HEALTH TECHNOLOGIESS	-0.32%
ATOMOS LTD	0.95%	KALIUM LAKES LTD	-0.26%
OPTICOMM LTD	0.85%	ACCESS INNOVATION HOLDINGS LTD	-0.20%
IMRICOR MEDICAL SYSTEMS-CDI	0.45%	NUFARM HYBRID	-0.16%
VAULT INTELLIGENCE LTD	0.23%	US MASTERS RESIDENTIAL PROPERTY	-0.08%

### Top 10 Relative Value Positions

BHP BILLITON - BHP BILLITON	INGENIA COMMUNITIES GROUP - LIFESTYLE COMMUNITIES LTD
KAROON GAS AUSTRALIA LTD - SANTOS	ARENA REIT - CHARTER HALL EDUCATION TRUST
RIO TINTO - RIO TINTO	CHARTER HALL RETAIL REIT - SHOPPING CENTRES AUSTRALASIA
TPG TELECOM LTD - UNITI WIRELESS LTD	APN INDUSTRIA REIT - GDI PROPERTY GROUP
IOOF – IOOF CALL OPTION	APN INDUSTRIA REIT - ELANOR RETAIL PROPERTY FUND

### Top 10 Special Situation Positions

PUT SPREAD ON ASX 200	SUNCORP GROUP NOTE
VOLPARA HEALTH TECHNOLOGIESS	ELECTRO OPTIC SYSTEMS HOLDING
NUFARM HYBRID	INVEX THERAPEUTICS LLTD
VILLAGE ROADSHOW LTD	ACCESS INNOVATION HOLDINGS LTD
ATOMOS LTD	IMPEDIMEDD LTD D

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](mailto:ellerston@linkmarketservices.com.au)

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