ELLERSTON CAPITAL

Ellerston Global Equity Managers Fund (GEMS)

Performance Report | December 2020

PERFORMANCE SUMMARY

Performance*	FYTD	CYTD	1 Year	3 Year (p.a.)	5 Yr (p.a.)	Since Inception (p.a.)^^
GEMS C	29.17%	38.19%	38.19%	9.78%	11.52%	12.68%

Source: Ellerston Capital

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

PORTFOLIO COMMENTARY & MARKET OUTLOOK

A January newsletter is supposed to be a good time to review the past year. We will definitely do that. We had a good year. But this time around, we do feel that the end of 2020 was like half time. Navigating 2021 and holding on to and enhancing the gains of 2020 is more important.

Performance

Your Ellerston Global Equities Managers Fund (GEMS) returned 38.2% net of all fees for Calendar Year 2020.

Returns as at the end of December are as follows:

	GEMS	ASX	MSCI World	S&P 500
One month	9.1%	1.2%	3.5%	3.8%
Three months	18.8%	13.7%	12.4%	12.1%
Six months	29.2%	13.2%	19.9%	22.2%
One year	38.2%	1.4%	13.5%	18.4%

Under the hood for 2020 (gross returns):

	1st Half	2nd Half
Long Side	(0.6)	50.6
Hedging Strategies	8.7	(15.3)
Gross Return	8.1	35.3

	Global
Average Net Exposure (monthly)	61.8%
Gross Returns	46.2%
Annual Return on Net Exposure	**74.7%**

Although the returns for the year were good, there were many mistakes made.

Our net exposure should have been higher. We anticipated a powerful liquidity driven rebound in Equity Markets, but captured it much more through good stock selection than carrying enough beta. A bit of beta enhancement would have made good returns even better.

Although we picked a few multibaggers, there were as many that got away. 2020, post the Covid correction was a year where analysis had to be done very quickly, in a week, in many instances. Otherwise, the sharp eyed global hedge fund community swooped to take prices away from fundamentally styled investors.

Investment Objective

The investment objective is to generate superior returns for Unitholders with a focus on risk and capital preservation.

Investment Strategy

The Fund provides investors with exposure to global markets through a long short equity strategy. The strategy overlays fundamental bottom-up stock selection with global macroeconomic and market outlook.

Key Information

^^Class Inception Date	1 December 2009
Co Portfolio Managers	Ashok Jacob & Arik Star
Application Price	$ 1.8947
Net Asset Value	$1.8900
Redemption Price	$ 1.8852
Liquidity	Monthly
No Stocks	98
Gross Exposure	214.84%
Net Exposure	90.80%
Management Fee	1.50%
Performance Fee	16.50%
Buy/Sell Spread	0.25%/0.25%

We did, however, do some things very right.

Our hedging strategy which was in place in January 2020 worked extremely well through February, March and April. We actually made money for the 1st half in a very trying environment. This strategy remains in place in January 2021, as it will for the foreseeable future.

A POWERFUL HEDGING STRATEGY THAT DEALS WITH TAIL RISK EVENTS SUCH AS COVID IS ESSENTIAL TO ANY ABSOLUTE RETURN INVESTMENT STRATEGY.

Strategies that are high returning often are exposed to tail risk events which investors are unaware of. Our focus is to hedge the tail risk events that we are at least aware of.

Oddly enough for us, we DID NOT see Covid coming, did not anticipate its short term impact on the stock market but still did pleasingly well in the first half of Calendar Year 2020. For us, even though we did materially better in the second half, we believe we demonstrated how an absolute return strategy should work.

The first half was about Risk Management. The second half was about Stock Picking. It is important to note, however, that without Risk Management, Stock Picking is irrelevant.

Portfolio Structure for 2021

Our Risk Management Strategy remains the same.

Layered protection.

Active and Passive Hedging.

A solid exposure to Gold.

Recently we have started hedging against market rotation by using factor baskets.

On the stock selection side, we are more excited by our portfolio than at any time in the past 10 years. The expected return on a stock by stock basis is the highest it has been since 2010.

Market Outlook

Tactically, we have a strong view that in the short term we will continue to see a market rotation. The significant stand out beneficiaries may be the Cyclicals of Yester Year.

The Global Stock Market is melting up. No one knows when it will end. No one knows how it will end. This market is driven by liquidity and the "Robin Hood Gang". It is very easy to dismiss the latter as a bunch of suckers whose time will come. We are not so sure. Around us is the carnage of value investors, leaving the industry permanently.

If liquidity and TINA are the fundamental drivers of this market, then what happens when the market has any sort of exogenous stock? Candidates include a weakening economy, vaccine complications, new mutations etc and most worryingly, an inflation scare. Well, we know the answer. Policy response/more liquidity! With Powell and Yellen, the policy response seems clear. In this environment for which there is no end in clear sight, what is the best way to invest? Call options on hyper growth stocks!

The world will recover hard. GDP growth everywhere could be >6%. Central Banks won't ease up. The flow of retail money into call premium is breathtaking. So, what are the problems looming? Higher rates? No chance, with the Fed determined to keep rates down.

We see two things that can upset the apple cart.

1. Inflation/Inflation Scare

There are clear signs of cyclical inflation emerging. Whether that is secular is unclear. Many commodities have exploded. Supply chains are in disarray. Conversely, energy prices are low and renters are paying way less than before. Consequently, an inflation scare is possible but not a certainty.

There is a dimension to this that investors should be very aware of. An inflation scare would normally see a sharp steepening of the yield curve. But, we do have clear indications that Central Banks will aggressively suppress yields in that scenario. However, they may not use that tool too early. What does that mean? Initially, a market sell off. (Good for traditional hedging strategies) but shortly after, a possible infusion of enormous amounts of Central Bank liquidity in an attempt to keep rates down. The consequences are good for volatility, good for hyper growth and good for gold. Hedging through this is a minefield that requires a clear understanding of the lens that Central Banks will use here and both the left and right tail risks that exist.

2. Vaccine Complexity

We currently have a myriad issues about the mooted vaccines that "Public Health Experts" are struggling to answer.

Does the vaccine cover new mutations?

Do all vaccines cover new mutations?

Why do some elderly folks appear to die from a certain vaccine?

Can you have two vaccines?

Most importantly, should you wait and not have the first vaccine made available to you? (As no one has tested vaccine combinations).

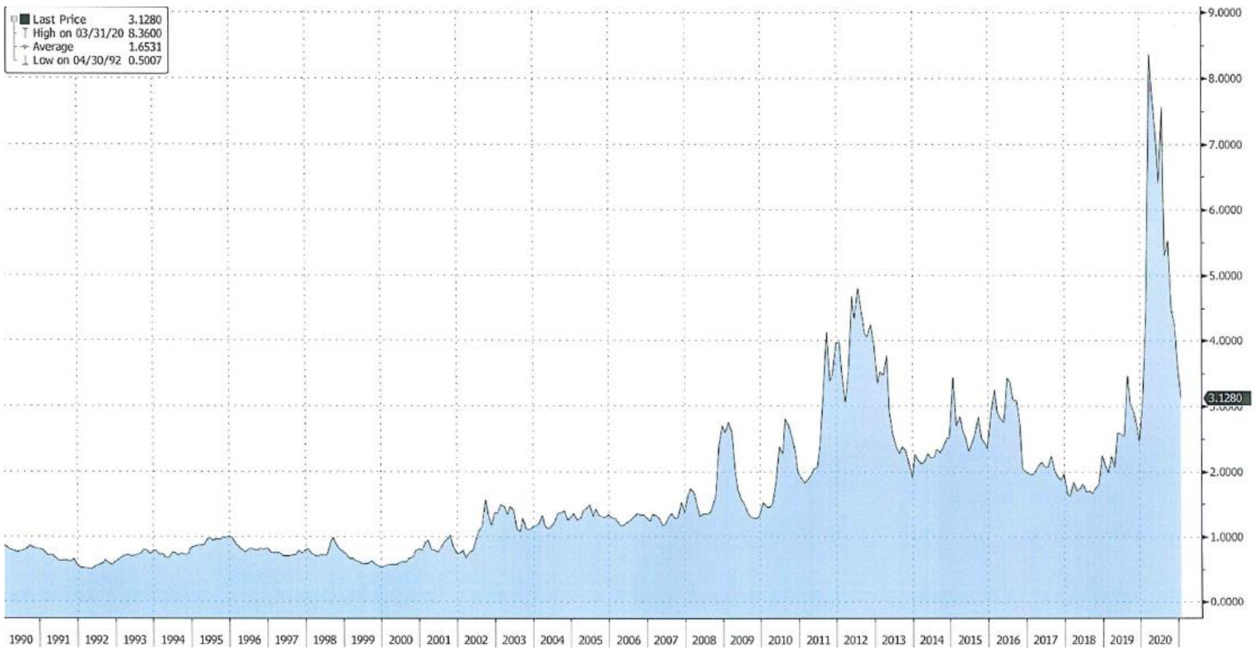
Will the vaccine makers need further time to study and modify existing vaccines to deal with a crisis that only gets bigger?

The point here is pandemics and vaccine complications may slow an economic recovery. ANYTHING OUTSIDE OF THE CONTROL OF GOVERNMENTS AND CENTRAL BANKS IS A THREAT TO RISK ASSETS.

A Market Outlook is incomplete without a reference to market valuations. Clearly there is a melt up in high growth, revenue multiple assets. This space is driven recently by Robin Hood style buyers now buying single stock calls relentlessly.

What is misunderstood is that call premium buying spent by relatively small investors is 4 standard deviations above anything ever seen. As an example, the second week of January saw retail buying USD 13B$ of call premium. The previous highest number was USD 2B$.

The rest of the market and sectors which are more traditional hunting grounds for fundamental investors such as financials, cyclicals and old economy stocks are at reasonable valuations compared to any previous market cycle. Relative to interest rates, they look inexpensive when factoring in a smidgen of inflation and a return of pricing power in sectors many thought were lost forever. The outlook is in fact quite exciting. Industries such as Cement, Pulp and Paper and Chemicals are stirring after a lost decade. They appear to have missed the last business cycle altogether. The younger investment brigade has lost all faith in the ability of these companies to deliver any returns whatsoever.



An old favourite above. The S&P earning Yld is currently 3 times the US 10YR Yld. Even with the 10Yr at 1.25%, this number is 2.7x. Since the start of QE in 2008, this ratio has been between 2 and 3. We identified in May last year that the SPX needed to get to 3900 to just get back in the range. This has happened and the equity valuation discount relative to rates is not as stark as before. If earnings rebound, the market clearly has the ability to rebound with it, but anything above 1.5% for the US 10YR will spell trouble unless earnings jump by 15%.

This is very broad brush but the valuations in the value end of the market appear compelling even in a rising rate environment. Tech does appear to be particularly vulnerable in that scenario.

Summary

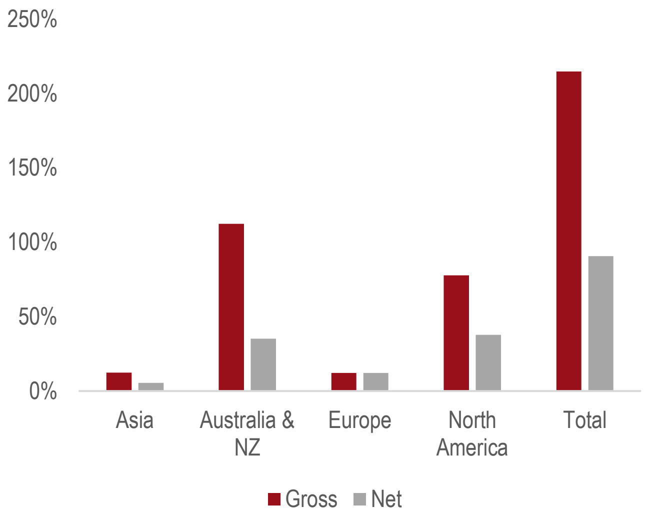
The "Actions" of the Fed, with QE 1, 2, 3, 4 and not QE and the Covid Liquidity Bomb, have created an irreconcilable impact in how Equities behave. "Liquidity" is the new "Value". The NEW FUNDAMENTAL DRIVER of Credit and Equity Markets. This may not end as many fundamentally driven Value Investors hope with another "Great Crash" style event. The next chapter may well be more liquidity and a "Financial Asset Hyperinflation". We are definitely seeing some signs of that today.

Unlike many previous stretched valuation markets of the past century, this one is different. The tail lies on both sides. A normal risk off environment like before or a volcanic shift from financial assets to hard assets.

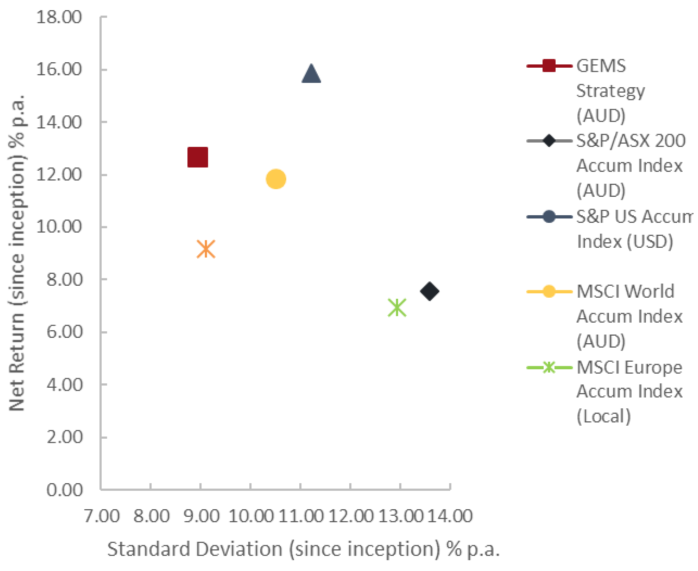
Happily, we have had a very strong start to 2021.

PORTFOLIO CHARACTERISTICS

Market Exposure as a % of NAV



GEMS Strategy Performance & Volatility^



Source: Ellerston Capital

Top 10 Holdings (Alphabetical, Long Only)

- ADAIRS LTD
- BED BATH & BEYOND INC
- BETMAKERS TECHNOLOGY GROUP
- CELSIUS HOLDINGS INC
- GRAINCORP LTD
- IMDEX LTD
- NEXTDC LTD
- SCIENTIFIC GAMES CORP
- SKY CITY ENTERTAINMENT GROUP
- UNITED MALT GROUP 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 7701 or info@ellerstoncapital.com

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