Ellerston Low-Vol Income Strategy Fund

Performance Report

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	$1.1434
Net Asset Value	$1.1405
Redemption Price	$1.1376
Liquidity	Monthly
No Stocks	30
Management Fee	0.70% p.a.
Performance Fee	10%
Buy/Sell Spread	0.25% On application 0.25% On redemption
Minimum Investment	$50,000
Minimum Additional Investment	$10,000
Distribution Frequency	Half Yearly (June & December)

Performance Summary

Performance	1 Month	3 Months	6 Months	1 Year	Since Inception (p.a.)
Net^	3.00	2.89	8.60	7.10	8.47
Benchmark*	1.45	3.00	11.47	6.48	6.47
Alpha	1.54	-0.11	-2.87	0.62	2.00

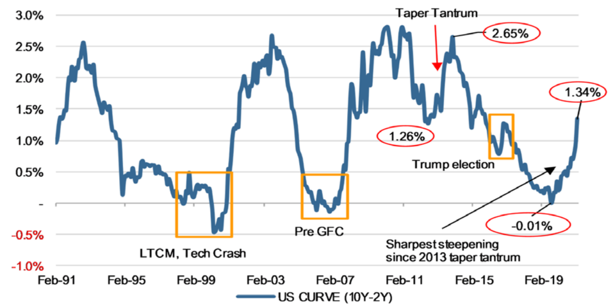
^ The net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance

*S&P/ASX 200 Accumulation Index

Portfolio Commentary

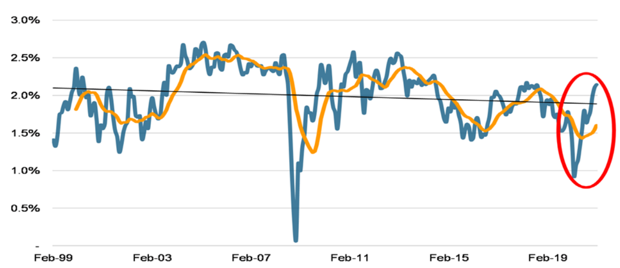
A sudden surge in bond yields in the last part of February caused a spike in equity market volatility but was not bad enough to unwind a solid month of gains in the market. The MSCI All Countries World Index rose 2.2%, with the ASX 200 lagging following an increase of 1.5%. This was despite the strongest February reporting season in years which saw positive earnings surprises surpass negative earnings surprises at a ratio of 3:1. Value continued its recent outperformance driven by a) superior earnings upgrades vs growth stocks and b) rising bond yields driven by surging inflation expectations. Furthermore, sharp gains in the copper / gold ratio point to bond yields moving higher throughout the year.

US Bond Yields – Rapid Acceleration



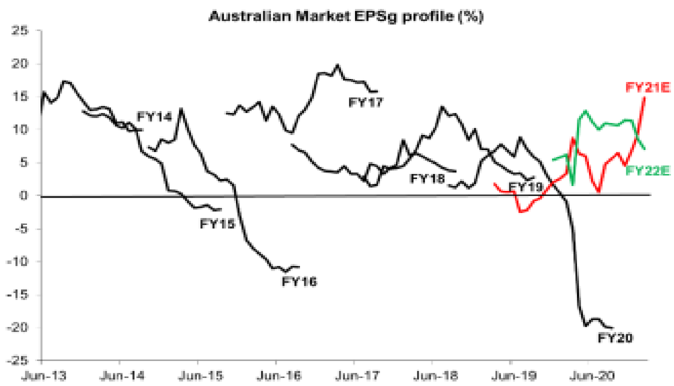
Source: JP Morgan

US 10 Yr Breakevens moving higher on inflation expectations



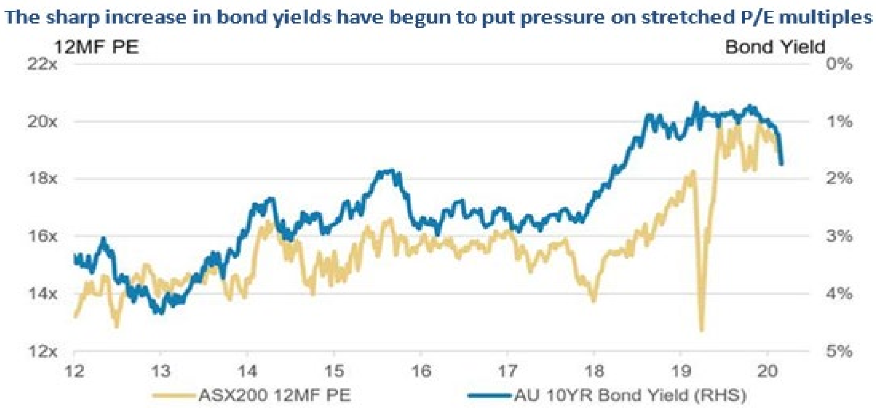
Source: JP Morgan

Notably, Australian earnings revisions for FY21 moved higher in February, driven mainly by bank earnings upgrades. However, we have seen downgrades to FY22 earnings growth as the effects of the stimulus program to fade.



Source: Macquarie Research

The global vaccine rollout and US fiscal stimulus saw investors buy into the "reflation trade" during February. Materials and Financials drove the ASX 200 higher, with the benchmark rising 1.5%. For the month of February, the fund outperformed its benchmark, with a relative performance differentiation of 1.54% on a net basis. The Fund achieved an absolute return outcome of 3.0% for the month, with value stocks continuing their outperformance. From a sector perspective, relative outperformance came from Financials (overweight Westpac & ANZ Bank), and Consumer Discretionary (Overweight Sealink). Mild sector performance detraction came from Materials (Overweight Northern Star). Given the meaningful premium the Australian market is trading on relative to its history, the impact of rising interest rates on valuation multiples could be quite pronounced should rates continue their upward trajectory.



Source: Morgan Stanley

PORTFOLIO ACTIVITY

During the month, we added Tabcorp Holdings into the portfolio as we believe the wagering business, with an expected transaction value of $3.0bn, leaves the Lotteries business being meaningfully undervalued by the market. We also undertook a switch out of Coles Group into Woolworths due to further expected market share gains by the latter, along with further upside potential from the impending demerger of Endeavour Group (Drinks & Hospitality Business). We also added Nine Entertainment back into the portfolio on valuation grounds as earnings momentum still looks very robust yet the stock continues to trade on modest valuation multiples.

Some of these purchases were funded by exiting Australian Finance Group, with the stock having rallied 35% since acquisition and looking fully valued. We also continued to move further underweight defensive stocks by exiting Austnet Services (bond proxy) and further reducing our exposure to expensive growth stocks by exiting Carsales.

MARKETS AND MACRO NEWS

Global growth expectations continued to be upgraded throughout February as ongoing consumer strength and a stronger than expected rebound in global activity continues to surprise on the upside. Global GDP growth for 2021 is now likely to run at around 6.5%, with the US likely to outpace China. Large upward revisions to global growth imply a rapid absorption of output capacity, especially in the US, reinforcing the broader global reflation expectation trajectory. Furthermore, the delivery of a further US$1.7tn stimulus package in the US looks highly likely to take effect in March, another catalyst to drive US unemployment down towards 4.0% by mid-2022 or earlier.

China's credit impulse is also a key factor in broader activity levels, especially infrastructure investment. This has turned down in recent times as policy normalisation, ie, credit slowdown, fiscal consolidation etc becomes a more dominant theme in 2021. China's credit impulse has a strong correlation to base metal prices and needs to be monitored closely.

Figure 17: China credit impulse vs base metals

Source: J.P. Morgan calculations, Bloomberg Finance L.P.

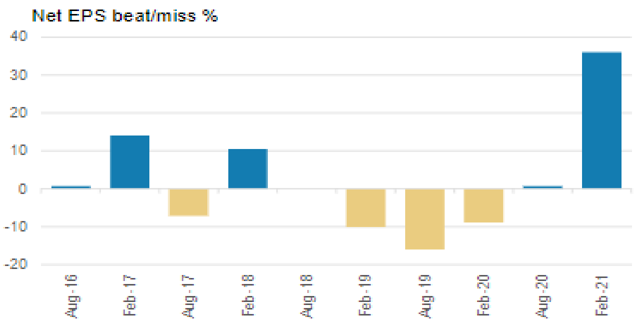
Economic activity indicators continue to improve in the US, with non-farm payrolls, retail spending and the composite services ISM running ahead of expectations. The US market (S&P500) ended the month 2.8% higher despite the bond market experiencing significant volatility. As earlier charts show, inflation expectations continue to move higher, driving bond yields up. European markets were equally stronger in February due to the vaccine rollout and stronger reporting season, whilst Asia was mixed.

On the commodities front, Brent oil prices rose 18% to US$66 per barrel due to OPEC maintaining current production levels and a cut back in production due to the big freeze in Texas. Base metals were broadly stronger with copper and aluminium prices rising over 10% for the month. Gold continued to struggle as real rates continue to rise on the back of renewed economic recovery optimism. The gold price fell to US$1,735 per ounce.

Global bond markets witnessed a meaningful sell-off as inflationary expectations surged. US 10 year bond yields increased 37 bps to 1.40% whilst Australian 10 year bond yields rose 79 basis points to 1.92%. We are approaching a potential bear market in bonds so will need to monitor this closely.

In Australia, earnings have done all of the heavy lifting, keeping the index within 6% of its pre-covid highs. The February results season saw a faster than expected start to the earnings upgrade cycle, with EPS growth for FY21 now expected to be around 16%. Most importantly, the ASX 200 dividends per share expectations rose 6.2% over the past month, the highest in the world. Energy and Financials saw the largest dividend upgrades.

Exhibit 2: EPS beats have been significant and are the highest on our records



Source: IBES, RIMES, Morgan Stanley Research

Despite these strong earnings upgrades, the market has had to deal with the 15th largest month on month move in US bond yields in 30 years on expectations that US inflation will move higher. This higher inflation expectation, along with extremely loose monetary and fiscal policy plus a weak USD has given strong upward momentum to commodity prices. This helped push the AUDUSD higher by 0.8%

Putting all this together, we expect the acceleration recently seen in global economic growth to begin to normalise as we move through 2021/2022. Earnings growth in the US will moderate off a very high base following a very strong earnings recovery in 2020. We are now seeing some pressure on share valuations from rising bond yields and do see this as a real risk as we move further into 2021, particularly for growth stocks. The Australian reporting season was one of the best in years, driven by strong earnings and dividend rebound across most sectors. Notably, we have seen further upgrades to FY21 earnings per share numbers for the ASX 200 but FY 22 has seen some earnings downgrades due to the base, or pull forward, effect. We are still cautious on the market in the near term given a) valuations are looking stretched vs history, b) cash weightings of fund managers are still low vs historical levels, c) around 60% of US stock dividend yields are now below the US 10 year bond yield and d) bond yields continue to rise.

The Fund continues to maintain its Cyclical Yield exposure to its highest level since inception without jeopardising its focus on earnings and dividend quality and growth. We anticipate that bond yields will continue to move higher at a faster rate than being anticipated by the market.
The beta of the Fund (a measure of volatility) sits at 0.95 vs a market beta of 1.00. The expected FY 21 dividend growth rate of investee companies held within the portfolio is comfortably above that of the market, at 38.8% vs 26.0% respectively. The expected dividend yield of investee companies held within the portfolio is currently 3.1%, 84% franked vs the market dividend yield of 3.3%, 78% franked.

Regards,
Chris Hall – Portfolio Manager, CIO

PORTFOLIO CHARACTERISTICS

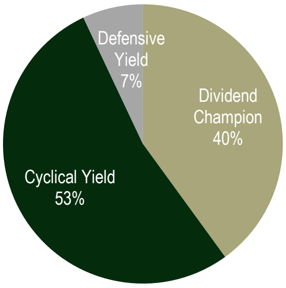
Top 10 Holdings

Westpac Banking Corporation	10.5%
Australia and New Zealand Banking Group Limited	7.9%
National Australia Bank	5.8%
Rio Tinto Limited	5.5%
Woolworths	4.4%
CSL Limited	4.2%
Tabcorp	3.7%
Sonic Healthcare Limited	3.6%
Ampol Limited	3.4%
OZ Minerals	3.4%

KEY PORTFOLIO METRICS

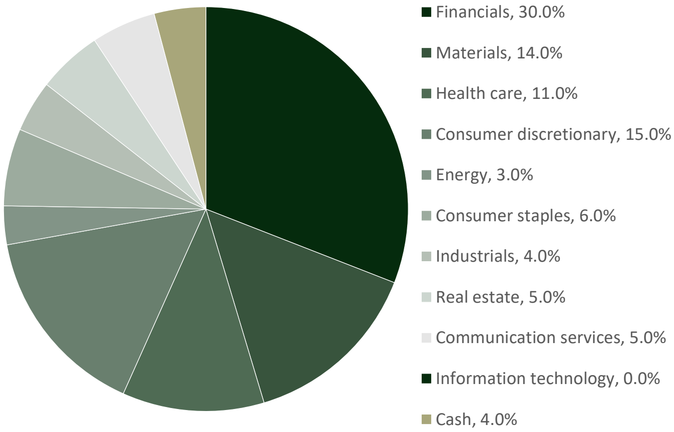
FY21(e)	Fund	Benchmark
Price/Earnings (x)	20.8	20.9
Dividend Yield (%)	3.1	3.3
Dividend Growth rate (%)	38.8	26.0
Beta*	0.95	1.00

PORTFOLIO YIELD EXPOSURE

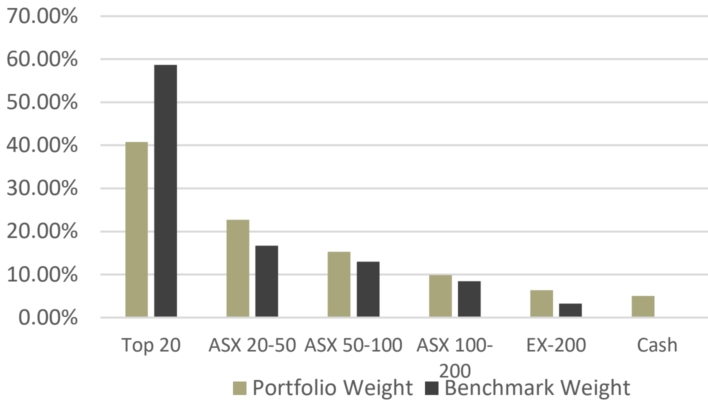


Source: Ellerston Capital

SECTOR ALLOCATION



MARKET CAPITALISATION



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Find out more

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