Ellerston Australian Share Fund (ASF)

Performance Report

Investment Objective
The Investment objective for the Ellerston Australian Share Fund is to outperform the S&P/ASX 200 Accumulation Index (Benchmark).

Investment Strategy
The Fund uses a benchmark-independent, high conviction approach that looks beyond investing in the Top 20 stocks in order to capture the neglected opportunities created by under-researched stocks in the broader Australian market.

Key Information

Strategy Inception	1 April 2009
Portfolio Manager	Chris Kourtis
Application Price	$0.9742
Net Asset Value	$0.9718
Redemption Price	$0.9694
Liquidity	Daily
No Stocks	21
Management Fee	0.90%
Performance Fee	15%
Buy/Sell Spread	0.25%/0.25%

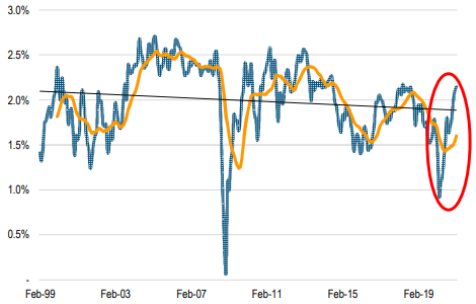
Net (%)	1 Month	3 Months	FYTD	Rolling 12 Months	5 Year (p.a.)	Since Inception (p.a)
ASF	2.99	1.96	18.31	5.36	7.83	8.04
Benchmark	1.45	3.00	15.20	6.48	10.74	9.74

Past performance is not a reliable indicator of future performance.

MARKET OVERVIEW

Global equity markets had a positive month but pulled back off their highs towards the end of February as the dislocation in the bond markets saw yields rise sharply. The ASX 200 ended the month in positive territory in a strong reporting season, but underperformed other developed markets. The Australian 10-year bond yields rose 79 basis points to end the month at 1.92%, and the AUD continued to firm as commodity prices remained buoyant.

USA
US stocks rallied as activity indicators pointed to the ongoing recovery in the US economy: composite services ISM improved ahead of expectation and non-farm payrolls rose in January too. A surge in US retail spending - up 5.3% in January - mostly driven by the US$600 stimulus checks from the December Response and Relief Act and a likely boost from the US$1.9 trillion stimulus plan saw economists raise expectations for US growth. The Dow Jones ended the month up 3.2%, the S&P 500 was up 2.8% (despite having hit several new record highs), with the Nasdaq Composite Index lagging, but still delivering a positive return of +1.0%. The US bond market experienced significant volatility as stronger recovery prospects drove up inflationary expectations - US 10-year breakeven rates have risen by 72 basis points over the past 12 months (see chart below).



Source: JP Morgan, Bloomberg.

Europe
European markets were much stronger in February as confidence grew that the vaccine rollout and a pickup in global growth would also support a recovery in Europe. Fourth quarter results were beating expectations of the STOXX 600 companies that had reported thus far, 70% exceeded estimates for earnings per share.

Activity indicators were mixed, but generally had a positive bias: Eurozone manufacturing PMI for January was in-line, flat at 54.8 (but marginally better than consensus at 54.7); composite PMI was also flat at 47.8 but slightly better than the consensus expectation of 47.5. The Euro STOXX 50 Index finished the month well into the green, up 4.5%. Among the major exchanges, France's CAC 40 was the best performer with a return of 5.6% and Germany's DAX delivered a healthy return of 2.6%. The UK's FTSE 100 was up more modestly in comparison at +1.6%.

Asia

Asian equity markets were mixed, although there were encouraging signs that China continued to expand. The January Caixin manufacturing PMI ticked up to 53.9, above consensus expectations of 52.6 and a previous reading of 53.0. The Hang Seng Index returned +1.4%, Korea's KOPSI delivered a negative return of -1.6%, but the Nikkei 225 was very strong, with a return of +4.7%, led by Japanese automakers which climbed following reports that Apple was in talks with several manufacturers as potential EV partners and solid earnings from Mazda Motor. The broader Chinese SSE Index was up 0.8%.

Commodities

Brent Oil prices rose again in February, up 18% to US$66 per barrel, driven by vaccine optimism, OPEC+ maintaining output levels, the Texan "big freeze" causing supply disruption and leverage to the reflation trade. Iron ore prices surged further, driven by expectations of higher global growth and constrained Brazilian supply, finishing the month up 11% to $US176 per tonne. Gold fell to US$1,735 per ounce as 'risk on' sentiment saw investors abandon bullion and gold shares. Base metals were also stronger, with Copper and Aluminium being the standout performers, up 15% and 11% respectively.

Bonds

Global bond markets experienced significant dislocation as inflationary expectations took hold (see a more comprehensive write-up in the Strategy section). The US 10-year bond yield rose 37 basis points to 1.40% and Australian bonds sold off more, with 10-year yields up 79 basis points to 1.92%.

Australia

The S&P/ASX 200 Accumulation Index ended the month in positive territory with a return of +1.5% and underperformed Developed Markets in February.

For the month, the Financials sector was the most significant contributor to the Index's performance, adding 142 basis points, followed closely by Materials, contributing 140 basis points and Energy, contributing 9 basis points. Every other sector detracted from the Index. Information Technology was the worst performer, with a return of -8.9% , detracting 37 basis points from the Index's performance, followed by Health Care (-0.3% contribution) and Consumer Staples (-0.3% contribution).

The best performing sub-index was the ASX 200 Resources Index, with a stellar +7.5% return, followed by the Small Ordinaries Accumulation Index, up +1.6% and the ASX 200 Industrials Index, with a return of -0.1%.

The top five stocks that detracted from the performance of the S&P/ASX 200 Accumulation Index were: Wesfarmers (-26 points), CSL (-21 points), Afterpay (-18 points), Coles Group (-17 points) and Northern Star (-15 points).

The top five stocks that made a positive contribution to the index's return were: BHP Group (+84 points), Westpac Banking Corporation (+49 points), Australia and New Zealand Banking Group (+36 points), Rio Tinto (+32 points) and Fortescue Metals Group (+20 points).

The AUD rose by 0.5 cents to 77 US cents and has now strengthened ~21% against the greenback in the past year.

COMPANY SPECIFIC NEWS

The Market Misses

Service Stream (SSM -39.6%)

SSM reported a very soft 1H21 result with revenues and EBITDA down 17.6% and 30.7% respectively versus 1H20. The soft result was accompanied by weak outlook commentary, with 2H21 results now expected to be flat on the 1H21 results. The weak margin result and outlook, along with the forecast loss of scale in the telecommunications business from FY22 onwards reflecting following prior contract changes, has led to material earnings downgrades for FY21-FY23, underwhelming investors.

NRW Holdings (NWH -29.7%)

Whilst FY21 revenue guidance of $2.2-$2.3bil was reiterated at the result, NRW was hit by around $70m in incremental costs in the first half, largely COVID-19 driven, which led to material misses to both EBITDA and NPAT versus market expectations.

Appen (APX -25.3%)

Whilst the FY20 result was broadly pre-announced, investors were clearly disappointed with the FY21 guidance. It appears the drivers of the late FY20 downgrade have persisted, with FY21 EBITDA guidance of US$83-90m approximately 20% below market consensus. A lesson learnt in the past 6 months is that APX's reliance on a small number of customers means it has very limited earnings visibility.

Kogan.com (KGN -22.3%)

KGN delivered incredibly strong numbers with EBITDA growth of more than 100% in 1H21. That said, the four-fold rally in the share price over the last 12 months and a 'slowdown' in January sales growth to 45%, left it vulnerable to profit taking.

Northern Star Resources (NST -20.5%) / Ramelius Resources (RMS -16.7%)

The gold sector was down ~10% for the month with gold prices falling 6%, given the sharp rise in bond yields. RMS reported weaker than expected 1H earnings due to a higher depreciation charge whilst NST's result was above consensus, however, with the merger between NST and Saracen Mineral Holdings which was implemented during the month, there is some uncertainty on the impact the merger has on some gold ETF's rebalancing, occurring in March.

Netwealth Group (NWL -18.5%)

Despite a headline beat for its 1H21 earnings, lower administration fee guidance was disappointing. Additionally, strong EBITDA margins are likely to normalise and there's downside risk if ANZ decides to renegotiate to a lower rate on cash accounts. After a very strong run (over 100% over the past 6 months) and trading on over 55 times next year's earnings, a pullback was not surprising.

Orica (ORI -17.7%)

Orica shocked the market with a meaningful earnings downgrade guiding 1H21 EBIT to be $105-$125mil below consensus expectations. The downgrade was also accompanied by the news that CEO Alberto Calderon will step down after six years in the role. Sanjeev Gandhi, a long time BASF employee who joined Orica in July 2020 to run the APAC business will take over as CEO.

Fischer & Paykel Healthcare (FPH -16.1%)

This manufacturer of in-hospital ventilators has been a big beneficiary of the global pandemic. The accelerating rollout of vaccines across most developed countries will inevitably dampen demand for the ventilators and the consumable ventilator accessories FPH also sells. The material movement in the NZD v the USD late in the month also negatively impacted the share price, given the majority of FPH's revenue is sourced from outside NZ.

A2 Milk Company (A2M -16.0%)

A2M provided investors with their third downgrade for FY21. This time, FY21 guidance was lowered to NZ$1.4bil from NZ$1.4-1.5bil and EBITDA margin guidance was reduced to 24-26% from 26%-27%, previously. A2M is continuing to blame a slower than expected recovery in the opaque daigou channel. Given current operating results, the lowered again guidance still implies a decent acceleration from 3Q21 to 4Q21. The stock has now halved since hitting lofty levels of ~$20 per share in July 2020.

The Market Hits

Zip Co (Z1P +43.1%)

Z1P shares surged after it was reported that the company was considering a US listing and the CEO went on an aggressive PR campaign highlighting the significant discount in rating relative to BNPL market darling, Afterpay. For the true believers, it helped that Z1P's reported stronger than expected gross margins which drove a beat on EBITDA despite ongoing losses.

Virgin Money (VUK (+39.5%)

VUK continues its impressive bounce as investors are increasingly comfortable with its earnings outlook and balance sheet, with the UK successfully rolling out vaccines. VUK still trades at a discount to book value, at 0.66 times but is significantly above its lows of 0.25 times.

EML Payments (EML +29.6%)

EML's 1H21 results were better than expected, underpinned by better-than-expected revenue and strong cash conversion. The top end of EBITDA guidance is now expected, with the PFS acquisition continuing its already solid contribution.

Sandfire Resources (SFR +27.6%) / OZ Minerals (OZL +20.1%)

Both companies benefitted from the 16% increase in copper prices during the month.

Lynas Rare Earths (LYC +25.1%)

Rare earths oxide (REO) producer LYC continued its run, with its major NdPr oxide rising a further 15% during the month. Also trade tension between China and the US has resulted in US President Biden launching a comprehensive review of America's critical supply chains for strategically significant products and resources, including rare-earth elements. LYC, well placed as the largest producer of REO outside of China, jumped on the announcement.

Vocus Group (VOC +22.3%)

VOC confirmed receipt of a confidential non-binding, indicative proposal from Macquarie Infrastructure and Real Assets (MIRA) and its managed funds to acquire 100% of the shares of VOC via a scheme of arrangement, at a price of $5.50 per share. The proposal is subject to number of conditions at this stage.

Corporate Travel Management (CTD +21.7%)

CTD's 1H21 results were ahead of expectations with improved cash burn of ~$4m for the first six weeks in 2021. With net cash of $119m and debt capacity of $178m the company has ample liquidity to ride out any medium term COVID-19 disruption. Further improvement in sentiment for travel demand drove the shares during February.

Nine Entertainment Co. Holdings (NEC +19.1%)

A strong rebound in advertising on traditional linear television, accelerating growth in digital advertising revenues from the broadcast and subscription video services (9Now and Stan) plus good cost control supported a better than expected earnings result and outlook for NEC. Confirmation that Google and Facebook will start to pay a material amount for news content shared on their platforms, gave investors confidence that the earnings recovery is sustainable, and the structural headwinds facing the traditional TV and newspapers divisions will be partly offset by these new revenue sources.

IDP Education (IEL +18.6%)

IDP Education reported a very robust result, given the difficult operating conditions, with revenue and earnings declines in the half not as severe as consensus expectations. Investors were encouraged by IEL's return to pre-COVID-19 levels in December and the appearance that prior digital investments were beginning to pay-off, which should expand gross margins.

FUND PERFORMANCE

The Fund performed well against the backdrop of a very busy reporting season and a bond market induced sell-off in global equities late in the month, where the market pared back its earlier strong gains.

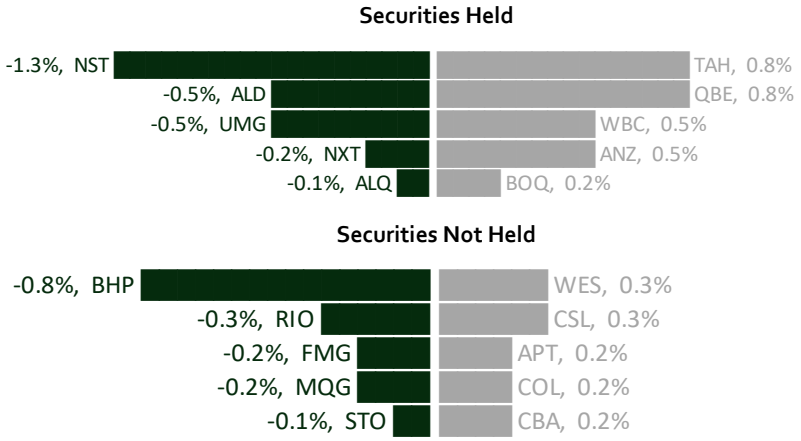
Pleasingly, the Fund was able to capture the upside, with a solid return of 3.08%, outperforming the benchmark return of 1.45%, mainly driven by its overweight stance towards the best performing financial stocks.

This brings the return for the 2021 FYTD to 19.19%, outperforming the benchmark return of 15.20%.

Returns[1] (%)	*Gross*	*Benchmark**	*Excess*	*Net*
1 Month	**3.08**	**1.45**	**1.62**	**2.99**
3 Month	**2.25**	**3.00**	**-0.75**	**1.96**
FYTD	**19.19**	**15.20**	**3.98**	**18.31**
Rolling 12 Months	**6.49**	**6.48**	**0.01**	**5.36**
5 Years (p.a.)	**8.98**	**10.74**	**-1.76**	**7.83**
Since Inception (p.a.)	**9.20**	**9.74**	**-0.54**	**8.04**

Past performance is not a reliable indicator of future performance.

Month of February Attribution



Source: Ellerston Capital.

The main positive contributors to this month's performance were overweight positions in: Tabcorp Holdings (TAH +13.4%), QBE Insurance (QBE +15.7%), Westpac Banking (WBC +12.7%), Australia and New Zealand Banking (ANZ +10.4%) and Bank of Queensland (BOQ +13.6%).

Zero weight positions that also helped included Wesfarmers (WES -8.3%), CSL (CSL –3.36%), AfterPay (APT -11.5%), Coles (COL -14.0%) and Commonwealth Bank (CBA -0.6%).

The main detractors to performance for the month were overweight holdings in: Northern Star Resources (NST -20.5%), Ampol (ALD -6.1%), United Malt (UMG -8.9%), Nextdc (NXT -3.5%) and ALS (ALQ -0.9%).

Not holding larger cap shares that outperformed the broader market and somewhat constrained returns included: BHP (BHP +12.8%), RIO (RIO +15.3%), Fortescue Metals (FMG +10.7%), Macquarie Group (MQG +8.4%) and Santos (STO -12.0%)

[1] The return figures are calculated using the redemption price for Class A Units and on the basis that distributions are reinvested. The Gross and Excess return figures are before fees and expenses whereas the Net Return figures are net of fees and expenses for the Class A Units. Returns of the Fund may include audited and un-audited results. Past performance is not a reliable indicator of future performance.

* The benchmark was changed from the S&P/ASX 200 Accumulation Ex REITS Index to the S&P/ASX 200 Accumulation Index on 1 July 2012.

FUND ACTIVITY

In February, the Fund was highly active and we took profits (in some cases completely exited certain core holdings intra month that rallied hard - namely QBE, DOW, S32) and conversely, selectively strengthened core holdings that lagged, but where we still see significant upside capture.

We exited the Fund's residual position in **Medibank**. Despite delivering a very credible result, we believe the outlook for the stock is stable but uninspiring, in the context of a market rewarding stocks with better growth prospects. Medibank also announced the retirement of well-respected CEO, Craig Drummond and this is likely to create some uncertainty until a new internal or external CEO is appointed.

We also exited the Fund's holding in **QBE Insurance Group** following its FY20 result release and spike in its share price. The results were mostly pre-announced and the outlook pointed to strong fundamentals by way of stronger premium rate rises. QBE has an interim CEO who did a very credible job at the results, painting a solid near-term outlook. But QBE is a re-insurance company with a history of negative surprises and is yet to announce a permanent CEO. We took the opportunity to sell into the strength following the result as the shares rallied to ~$9.50, finishing the month up 15.7% at $9.29.

We reintroduced **Janus Henderson** into the portfolio, a stock we are very familiar with. The shares have underperformed recently and following an excellent results update (best in many years), we feel the stock now looks attractive again. Net outflows have moderated significantly, performance across most asset classes has improved markedly, with quantitative equities (INTECH) being the only source of ongoing disappointment and margins are holding, with clear guidance on costs provided. Earnings were upgraded following the result and the stock trades on 9.1 times FY21 and 8.8 times FY22 consensus earnings forecasts. The balance sheet is robust and the dividend yield of around 5% is highly attractive.

NEW STOCKS ADDED	STOCKS EXITED
• Bank of Queensland	• Downer EDI
• Janus Henderson Group	• Medibank Private
	• QBE Insurance Group
	• South32

INCREASED	DECREASED
• Deterra Royalties	• Fletcher Building
• NextDC	• Woodside Petroleum
• Northern Star Resources	
• Tabcorp Holdings	

Bank of Queensland (BOQ)

On 22 February, BOQ announced its intention to acquire 100% of ME Bank for $1.35b. The capital raising was by way of a rights issues and an institutional placement. The offer price was $7.35 per share, which we deemed very attractive so we participated in the raising.

Strategic and financial logic

The acquisition of ME Bank delivers material scale to the combined group along sound strategic lines and the financials are compelling too. The number of customers increases from ~0.9m to ~1.45m. Retail banking gross loans and advances (GLAs) broadly doubles to over $57b, increasing the contribution from retail banking to over 50% from 35%. It diversifies BOQ's East Coast presence from being Queensland centric (Queensland GLAs reduce from 42% to 31% of the loan portfolio, New South Wales increases to 29% and Victoria to 21%). All of the combined group's brands have higher net promoter scores and the acquisition will further accelerate BOQ's digital strategy.

Importantly, the financial outcomes are very attractive. On an underlying cash EPS basis and including a full run-rate of synergies, the deal is expected to deliver low to mid double-digit earnings accretion in the first full year. The transaction is also expected to be accretive to ROE by over 100 basis points, including full run-rate synergies. BOQ expects to extract pre-tax synergy benefits of between $70-$80m. The synergies represent approximately 10% of the combined group's cost base and seem reasonable. No revenue synergies are assumed at this stage. Further potential upside may also be achieved from reduced wholesale funding costs and lower investment capex.

Overall, the acquisition consideration of $1.35b implies 11.9x FY20 cash earnings after tax (excluding synergies), approximately 8.0x FY20 cash earnings after tax (including a full run-rate of synergies in year 1) and equates to 1.05x FY20 book value. The combined group's balance sheet remains strong, with a pro forma capital ratio or CET1 of 9.8% and pro forma deposit to loan ratio of ~70%.

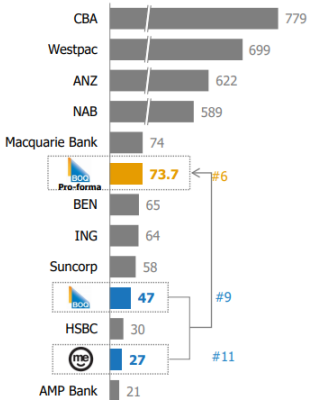
Acquisition delivers significant scale

SIGNIFICANT INCREASE IN SCALE

FY20		BOQ (Aug YE)	me (June YE)	BOQ Pro Forma (ex synergies)[1]
Balance Sheet	Gross Loans and Advances ($bn)	47.0	26.7	**73.7**
	Total Assets ($bn)	56.8	31.5	**88.3**
	Deposits ($bn)	39.6	17.2	**56.8**
	Book Equity ($bn)[2]	4.2	1.6	**5.9**
Income Statement	Total Revenue ($m)	1,096	481	**1,578**
	Total Expenses ($m)	594	287	**881**
	Cash NPAT ($m)[3]	319	124	**442**
KPIs	Net Interest Margin	1.91%	1.56%	**1.78%**
	Cost to Income	54%	60%	**56%**
	Cash Return on Equity[2,3]	7.6%	8.1%	**7.6%**
	CET1 Ratio	9.8%	9.9%	**9.8%**
	Customers (#)	~900k	~550k	**~1,450k**

STRONGER MARKET POSITION

Gross loans and advances ($bn)[4]



Source: Company presentation.

Strong 1H21 trading update from BOQ

Pleasingly, BOQ delivered a 1H21 update that was materially better than consensus expectations and revised its FY21 outlook positively. In the half, cash net profit is now expected to be grow by 8-10%, implying $163-$166m. This was driven by strong GLA growth of 5% (1.2x system) in Housing which offset the slightly negative to flat Business GLA growth (system: negative), and positive NIM, up 3 basis points on 2H20. Despite some cost growth, positive 'jaws', where revenues are growing faster than costs, were a key feature. The loan impairment expense was a mere 10 basis points of GLAs, with the group sitting on sufficient credit provisions in the face of improving macroeconomic conditions.

The FY21 guidance was as follows:

- Around 1% positive jaws (vs. "broadly neutral" jaws)
- Above system growth in lending (no change)
- NIM slightly positive (vs. 2-4bps decline)
- Cost growth of 3% to support the growth momentum of the business (vs. cost growth of 2%)
- Divestment of St Andrew's expected to be completed in 2H21
- Dividend payout ratio target range of 60 – 75% of cash earnings for FY21[3]

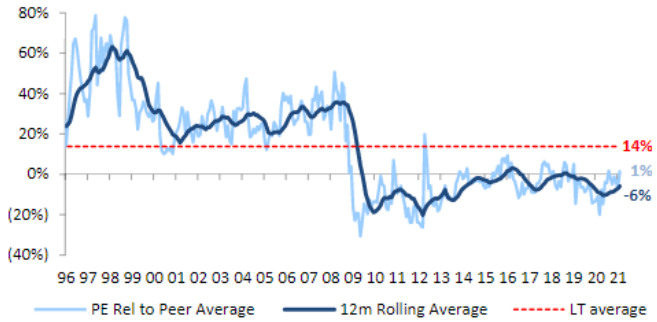
While the ultimate dividend decision is at the discretion of the Board at the time of the results, the guidance on dividends is attractive. In fact, the 1H21 dividend of approximately 17 cents per share will be paid on new shares issued through the capital raising too.

Conclusion

The acquisition clearly gives the enlarged BOQ material scale benefits and financial accretion. While ME Bank did not have a track record of high growth, the multi-bank approach and focus on the retail segment should provide attractive and profitable growth opportunities for the group. The synergies are indeed compelling and representations made by management lead us to believe they are achievable, with potential upside likely. Consensus earnings expectations have increased materially.

The banks sector has outperformed recently and has been re-rated, partly due to the renewed attractiveness of resumed dividends, and earnings being supported by revenue growth and the expected release of excess credit provisions. BOQ has joined the bank sector rally, but is trading at a significant discount to its peer average relative to its historical trading range.

BOQ: PE versus Major Banks



Source: Refinitiv, Morgan Stanley Research.

The $7.35 per share capital raising represented a very attractive entry point as the combination of operational improvement and leveraging acquisition synergies is appealing.

Tabcorp (TAH) update

TAH was introduced as one of the highest conviction positions to the portfolio back in October 2020 in the mid $3.00 region. Since then, it has been a positive contributor to alpha generation. We recount that the reasons for establishing the position, as outlined in our October newsletter, were:

- TAH's core business is an attractive Lotteries & Keno operation with long dated monopoly licences, structural tailwinds from an ageing population and digital migration, resilient demand and strong cash generation.
- TAH's under-appreciated wagering business was exhibiting signs of earnings stabilisation, after years of declines as pricing was reset and retail customers migrated to online only competitors.
- The relatively small gaming services business, Max, will bounce back from the COVID-19 induced earnings decline and more than likely be sold to reduce debt.
- The valuation was compelling without heroic assumptions for the Wagering business or Max. An EV/EBITDA multiple of 17x for Lotteries is easily justifiable, if not greater, given its infrastructure like qualities, previous takeover interest in the business and the broader movement in bond rates and earnings multiples since that takeover interest emerged in 2016.

The investment thesis, so far, is playing out as planned. The earnings result in February underscored the first two points. TAH's 1H21 result pleasantly surprised and was ~30% ahead of consensus (adjusted NPAT). Result quality was high, given EBITDA cash conversion of 145% versus only 73% in pcp and 134% in 2H20.

Lotteries & Keno (L&K) beat expectations on both revenue and margins, despite an unfavourable jackpot sequence that saw lotteries sales flat yoy. No trading update was provided, but we estimate lotteries sales will grow ~20% yoy in 2H21 (Jan >50% yoy). The announcement of a potential Oz Lotto game change is also positive, given encouraging results from other recent initiatives (although we already factor in regular price rises and game enhancements into our forecasts).

The Wagering & Media (W&M) result also beat expectations. It was very strong, despite COVID-19 forcing the closure of many of the retail outlets for a large proportion of the half. That said, TAH's digital market share losses remain of concern and needs to be monitored. Cost control was a big positive across the group - cost out and underlying growth - with more to come from the 3 year optimization program. Gearing is now comfortably within the target range, especially after strong cash flow conversion.

The valuation gap we highlighted back in October has only partly closed as a result of the strong earnings performance and resumption of dividend payments, but also driven by "a number of unsolicited approaches" in relation to the purchase of its Wagering & Media division, confirmed by TAH in early February. The emergence of this genuine M&A interest from multiple parties, along with better than expected earnings results and a revitalized Board under fresh stewardship, means there is still significant upside for the TAH stock price.

In fact, our level of conviction has increased, as consensus upgrades to the Street's earnings forecasts and valuations means the current share price at $4.45 is significantly mispriced. We expect further value to be unlocked in coming months, when TAH's board is likely to formally respond to the "approaches". As such, TAH continues to be a large position in the portfolio.

FUND STRATEGY AND OUTLOOK

The Developed Markets long duration bond sell-off and the commensurate rise in real yields, which began on February 10th, proved hugely destabilizing with investors enduring a broader de-risking phase in late February across Equities, Emerging Markets risk assets and also in the key Commodity complex. The spike in bond yields has been astonishingly swift and brutal, testing the resolve of global central banks to keep monetary policy accommodative.

The market is becoming increasingly paranoid about fiscal stimulus and easy money causing higher inflation, hence the need for central banks to pivot and tighten monetary policy. We believe that the Fed is expected to look past this current volatility and hold off on any rate adjustments. Rising rates are not necessarily bad for equities or economies, as it always depends on why rates are squeezing higher. If driven by economic recovery with modest inflation, equities should continue to do well. Higher bond yields are not necessarily bad for equities, as long as the earnings growth is supportive and February was the best reporting season in many years, despite COVID-19. The main negative impact in the recent past has been on Growth, long duration sectors like Tech, Infrastructure, REITs, Media and the like, which have all sold off sharply from their recent highs.

Whether this growth sell-off is a temporary blip or a more permanent trend, only time will tell.

Like us, most investors have been surprised by the pace and volatility of the rise in bond yields, but not surprised directionally. Domestically, Australian 10-year yields shot up in the month from 1.13% to 1.92%, before settling back to 1.69% at the time of writing. As did equity markets last year, the bond market is clearly pricing in a rapid re-opening and synchronised global recovery. In the few years before the outbreak of COVID-19, Australian 10-year yields were averaging ~ 2.5%. Yields trended sharply lower towards the back half of calendar 2019 as growth concerns in Australia followed severe drought conditions and bushfires which made press headlines daily. The reverse is true today, as the Federal Government bravely delivered one of the largest fiscal stimulus packages of any G20 nation and has managed the pandemic relatively well by world standards.

It is unlikely the Fed or RBA will taper its asset purchases any time soon, but investors are starting to question their forward guidance on policy, so the markets' behaviour is somewhat perplexing. Central bank officials from the US, Europe and Australia have all reiterated existing policies by committing to keep interest rates low. From US Fed Chair Powell: "the US economy is still a long way from the Feds goals, substantial further progress toward goals will take time and Fed is nowhere close to pulling back support". Similar sentiments from the RBA's "maximum dovish" easing stance at its recent February meeting and reiteration to keep rates on hold "until at least 2024" - Governor Lowe at the March 2 RBA board meeting: "At its meeting today, the Board decided to maintain the current policy settings, including the target of 10 bps for the cash rate". Further, from the ECB's President Lagarde: "It remains crucial that monetary and fiscal policy continue to work hand in hand."

The consensus view is that inflation does not pose a serious threat and that any inflationary pressure stemming from supply-chain constraints should be deemed by central banks as "temporary". As the consumer rotates back into services upon reopening of economies, any potential supply-chain pressure should be alleviated. That said, central banks do need some inflation in the system and US Federal Reserve Chair Powell has made it clear that it will let inflation run above its 2% target before hiking interest rates. History has shown that inflation should only be of concern if it is accompanied by weak economic growth and or excessive central bank tightening at the wrong point in the cycle - neither of those two conditions are present today.

So whilst higher real yields have historically hurt equities, much higher synchronised growth should cushion this impact. Equities are still in a goldilocks zone, but expect elevated volatility.

This reporting season was one of the best in years. By the end, 52% of stocks beat expectations on EPS. The positive surprise was driven by better-than-expected margins, rather than higher revenues. The stocks that beat on EPS were in two camps, those with leverage to global reflation (like BHP, RIO, Fortescue Mining and BlueScope Steel) and so-called COVID winners (like JB Hi-fi, Corporate Travel, Webjet, and Domino's Pizza Enterprises etc).

By far, Banks were the star of the reporting season, with significant beats driven by lower impairment charges but strong underlying improvements too. Financials and Resources saw positive earnings revisions and there is now a consensus view that these are the sectors to be in as the reflation trade builds. According to Macquarie Research, of the 184 stocks that have reported, EPS estimates were upgraded for 37% and downgraded for 25%. This is an upgrade to downgrade ratio of 1.5 times, compared to 1.1 times in the last reporting season in August. Also, dividend expectations are robust and following the reporting season, there were material upgrades to dividends with Energy and Financial topping the table.

As you would be aware, since October we have been lifting our exposure to the major banks. In February, our three major bank holdings provided quarterly updates. We have summarised these below. The updates are very supportive of our positive positioning.

Summary of the quarterly updates from NAB, WBC and ANZ (in order of reporting)

NAB: NAB's solid 1Q21 trading update on 16 February provided further confirmation that the economy is well on the mend. Cash net profit after tax (NPAT) was $1.65bn, up 47% on pcp and way ahead of consensus expectations. The large beat relative to expectations was primarily driven by a very low credit impairment charge of just 1 bpt (not a typo) and a foretaste of a trend from the other two majors and likely for the year ahead. Management flagged some positive "momentum" in its core businesses.

Pleasingly, excluding the more volatile markets and treasury income, revenue was up by 1%, driven by increased fee income on the back of a pickup in business activity. Net interest margin (NIM), excluding markets and treasury, was broadly flat, as the bank benefitted from widening deposit spreads. Expenses were down 1% and tracking ahead of guidance, marking a change from several halves of regulatory and compliance driven increases. Management again reiterated its commitment of underlying expenses growth of 0-2%. So-called positive 'jaws', where revenue outpaces expenses, are a likely to feature for the sector in the medium-term. Underlying credit quality also improved markedly, with NAB taking a mere $15m impairment charge or 1 bps of gross loans and advances - likely to be the lowest in its history. Despite this, NAB's provision coverage remains towards the top-end of peers at 1.78% of credit risk weighted assets. Economic conditions are much improved, especially with respect to the original dire economic assumptions that drove the collective provisions and overlays taken at the start of the pandemic. These improved assumptions have led to no further increase in provisions. To top it all off, the capital position of the bank is strong, with CET1 at 11.7% (and pro-forma CET1 expected to be over 12% following the completion of the sale of MLC wealth to IOOF in the middle of the year).

WBC: WBC's 1Q21 update on 17 February was bullish. The outlook statement from the CEO, Peter King, struck an upbeat note, signalling a turnaround in WBC's fortunes from the prior *annus horribilis*. Cash NPAT of $1.97bn was 45% higher than consensus VA expectations. Again, the significant beat relative to expectations was primarily due to a much better outcome on impairments. WBC became the first of the major banks to release provisions and recognised a $501m "impairment benefit". Operating trends were also positive, with NIM improving (up 3bpts) and costs lower.

Underlying revenue was better than expected, driven by flat net interest income. Flat volumes were offset by an improvement in NIM - lower funding costs and widening deposit spreads (a recurring theme) offset competitive pricing pressure. In a notable surprise, underlying costs fell by 2%, but this was mainly due to the deferral and timing of project spend. The bank did caution that it expected project costs to reappear over the year. However, it did commit to a detailed three-year cost update with the half year results. Despite the significant benefit to quarterly earnings from the write-back of credit provisions, it was encouraging to see underlying pre-provision operating profit increase by 3.0%. WBC released approximately 10% of its credit provisions as the better economic outlook (improved GDP growth, employment and house prices) drove a change to economic loss assumptions and there were improvements in the asset quality across the book. Importantly, with respect to capital, WBC may have definitively answered those critics who as recently as late last year were accusing the bank of having inadequate capital levels, with a CET1 of 11.9% (40bps above expectations). The jump in CET1 was mainly driven by the lower credit risk charge from the decline in risk weighted assets. The capital of the group should benefit from the divestment of identified non-core assets over the course of the year.

ANZ: ANZ released its 1Q21 update on 18 February. It was a very strong result and 46% ahead of consensus, where for the first time in a long time, almost everything went right. Cash NPAT excluding notable items was $1.84bn. Once again, the market was wrong footed by being overly pessimistic on impairment charges. ANZ become the second major bank to release some of its collective provisions, recognising an "impairment benefit" of $150m in the quarter.

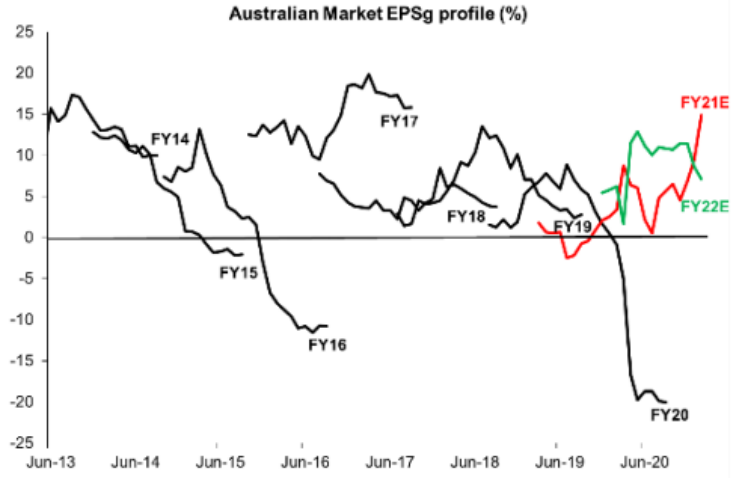
The standout was the stronger than expected revenue performance, up 4% (excluding weaker markets revenue) on 2H20 average. The bank called out market share gains in the Australian home loan market, coupled with NZ continuing to benefit from the housing boom. NIM was up 5 bps or +3 bps excluding markets and treasury. The NIM benefitted from better wholesale funding, deposit pricing and favourable asset pricing. (It is remarkable that Australian banks can still price in their favour. But it speaks to the power of lingering oligopolistic pricing and having earned some political currency by playing an important role for 'Team Australia' when the pandemic hit the economy.) Expenses were flat relative to 2H20 average and ANZ has continued to remain disciplined on this front. Pre-provision operating profit was slightly down but beat expectations by more than 5%. Capital was again strong, with CET1 of 11.7%. The overall tone was positive on the outlook and management commentary seemed to hint at capital management over time.

Conclusion - Banks

Overall, the quarterly updates have led to material earnings upgrades and bode well for positive dividend and capital management expectations. As previously indicated, we expect that dividend pay-out ratios will trend to 70% plus over the coming 12-18 months. A number of analysts are now even factoring in capital management in the form of buy-backs into forecast expectations. While the three banks mentioned above have rallied sharply off their lows, they are still trading at a significant discount to CBA and relative to historic valuations. The path to improved ROEs is now clearer and this should see further expansion of the price to book multiples, albeit with more modest upside. We feel the majors should remain supported as institutions continue to close their underweight positions. Additionally, the implied dividend yields above 4% are increasingly attractive in this environment of low interest rates.

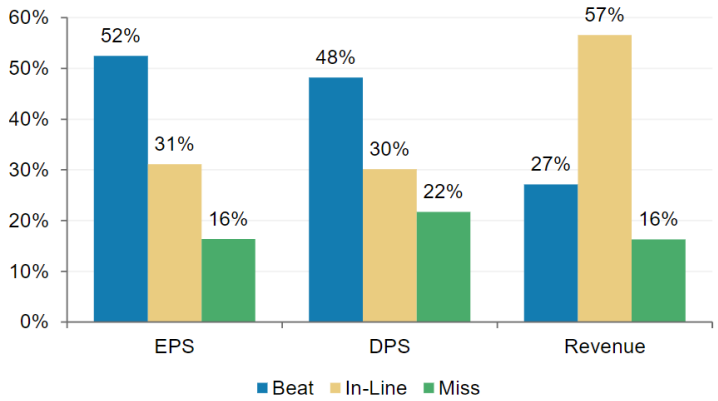
Macquarie Research is now forecasting FY21 EPS growth to be +14.8% (from +6.9%) following the reporting season for the Australian Market.

FY21 EPS growth forecasts in an upgrade cycle driven by Financials and Resource stocks



Source: Macquarie Research, February 2021

Disaggregating revenue, EPS and DPS revealed that earnings beats significantly outperformed misses by 3.2 times in February, while DPS beats were also a strong performer.

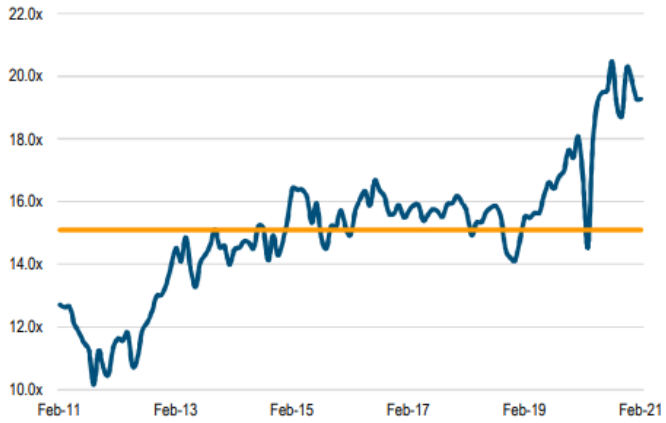


Source: Morgan Stanley Research on coverage by Morgan Stanley analysts only.

We again witnessed in February multiple expansion across the majority of global markets. The Developed Market forward multiple expanded by 0.6 times to 20.4 times. In Australia, we are seeing earnings being revised up and with the exception of the Small Cap Index, which saw a marked expansion in its multiple, the majority of Australian indices contracted last month. In particular, the ASX 50 contracted despite a strong move higher in the price of the Index. The substantial increase in earnings more than offset the lift in the index.

MSCI Developed Market 1-year forward PE

ASX 200 1-year forward PE

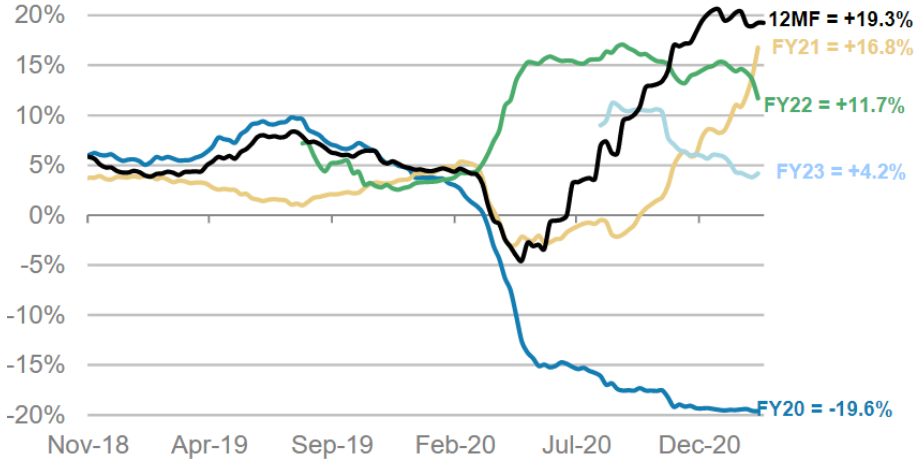


Source: JP Morgan, Bloomberg

An upgrade cycle was certainly required to justify full valuations and the earnings did not disappoint. The market PE, based on 12-month forward earnings which was over 20 times, has now fallen back towards 19 times. The movement in the yield curve has obviously been a contributing factor, together with earnings upgrades.

One example this month of how quickly markets can change their tune and the risk of being 'priced for perfection' was with data software platform company **Nuix** (NXL). NXL, a growth market darling, quickly shot up post IPO listing to trade on ~15x FY21E price to sales, prior to reporting its 1H21 result on the final day of February's reporting season. This very well-supported data scraping IPO stock was priced at the beginning of December 2020 at ~9x price to sales and was re-rated on day 1. NXL had some small delays in contracts from December to January but still reaffirmed their FY21 prospectus guidance, however, investors were clearly unimpressed with the 4% YoY decline in revenue, sending the stock down 32% on the day of the result!

Aggregate Annual Consensus EPS growth (%) Trends FY20-23



Source: RIMES, IBES, Morgan Stanley Research.

Overall, our strategy remains the same. We continue to be invested in stocks we believe are trading below our assessment of value and where the market is underestimating their future medium term earnings. We will remain vigilant especially with respect to rising inflationary expectations and any future dislocations in the bond market. Central banks are determined to keep rates low, but stronger growth might force a reassessment if there are signs that prices are facing upward pressure from supply constraints and importantly increased demand.

To summarise your portfolio's positioning:

1. Quality Franchises, Growth at Reasonable, Attractive Valuations

Solid companies with strong/leading market positions and credible management with good balance sheets
James Hardie Industries, NextDC, Reliance Worldwide, United Malt, Treasury Wines and ALS.

2. Businesses that are highly cyclical or seasonal in nature, facing headwinds

Heavily discounted companies with strong market positions and strategic assets, but very sensitive to economic conditions/seasonality/weather
Graincorp, Nufarm and Ampol

3. Turnarounds

Sound businesses that have historically generated poor returns, have been poorly managed, under-earned versus their potential, are in transition and where we think earnings/returns will improve over the medium term. Out of favour with the market, somewhat contrarian positions
Fletcher Building, Janus Henderson and Tabcorp Holdings

4. Deep Value Resource Plays

Stocks trading at discounts to NPVs, where much of the heavy lifting has been done (cost out, self help deleveraging)
Woodside Petroleum, Deterra Royalties, Western Areas and Northern Star Resources

We continued to lift the weighting in Financials, where we now own three of the big four bank, one regional bank in Bank of Queensland and Janus Henderson.

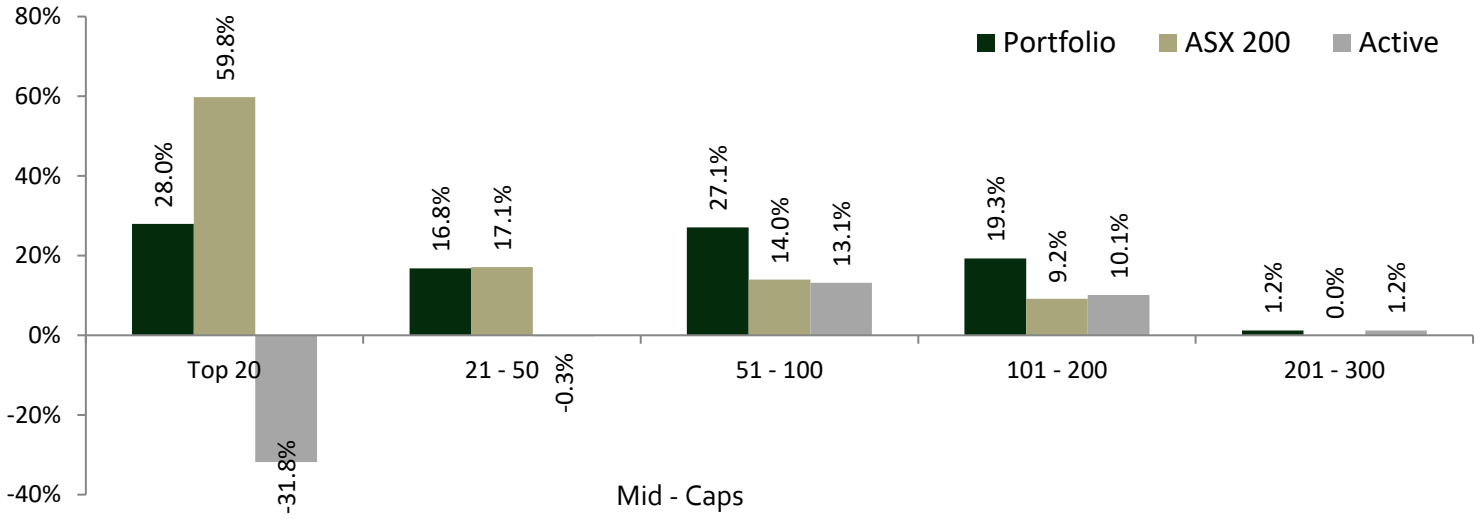
Warm Regards,

Chris Kourtis

Portfolio Manager

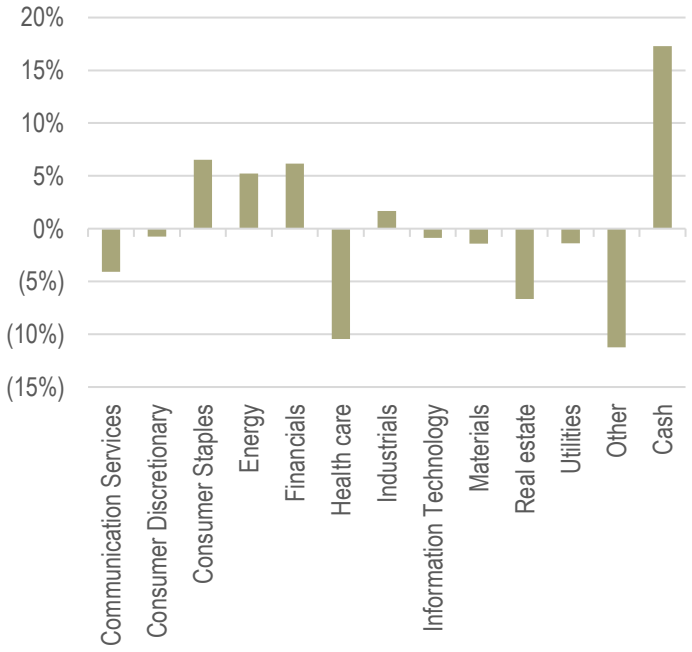
PORTFOLIO FEATURES

Size comparison Chart vs ASX 200^



^Size Comparison Data as at 26 February 2021
Source: Bloomberg, Ellerston Capital Limited

Active Sector Exposures*



TOP 10 HOLDINGS**
ALS
AMPOL
ANZ BANKING GROUP
GRAINCORP
NATIONAL AUSTRALIA BANK
NEXT DC
NORTHERN STAR RESOURCES
TABCORP HOLDINGS
UNITED MALT GROUP
WESTPAC BANKING CORP

Source: Ellerston Capital Limited

* Active sector exposures are determined by subtracting fund sector weights from benchmark weights. Positive percentages represent over-weight sector exposures relative to benchmark and negative percentages represent under-weight sector exposures relative to the benchmark.
** Top 10 Holdings are listed in alphabetical order.

About the Ellerston Australian Share Fund

The Fund aims to achieve its performance objectives by adopting a fundamental "bottom-up" investment approach to stock selection which is focused on identifying and then constructing a portfolio of the highest conviction ideas.

Investment opportunities for the Fund are identified by analysing and understanding the factors affecting (amongst other things): business model, industry structure, management team and overall valuation. Ellerston Capital typically favours businesses that can sustain high returns or improve their return on capital and looks to invest in businesses with a market value below the value we attribute to them.

Benchmark weightings do not drive our stock decisions, our approach is totally benchmark independent.

Due to the high conviction nature of the portfolio and the resulting deviation in portfolio composition relative to benchmark weighting, it is expected that the returns from the Fund will differ significantly from the broader market indices.

FUND FACTS

STRATEGY FUNDS UNDER MANAGEMENT	**$.9Billion**
FUNDS UNDER MANAGEMENT – ASF UNIT TRUST	**$15.38 Million**
APPLICATION PRICE	**$0.9742**
REDEMPTION PRICE	**$0.9694**
NUMBER OF STOCKS	**21**
INCEPTION DATE	**1 APRIL 2009**

Source: Ellerston Capital Limited

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Find out more

All holding enquiries should be directed to our register, 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 or visit us at **ellerstoncapital.com**

Ellerston Capital