Ellerston Low-Vol Income Strategy Fund

Monthly Newsletter, May 2021

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	$1.2734
Net Asset Value	$1.2702
Redemption Price	$1.2670
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

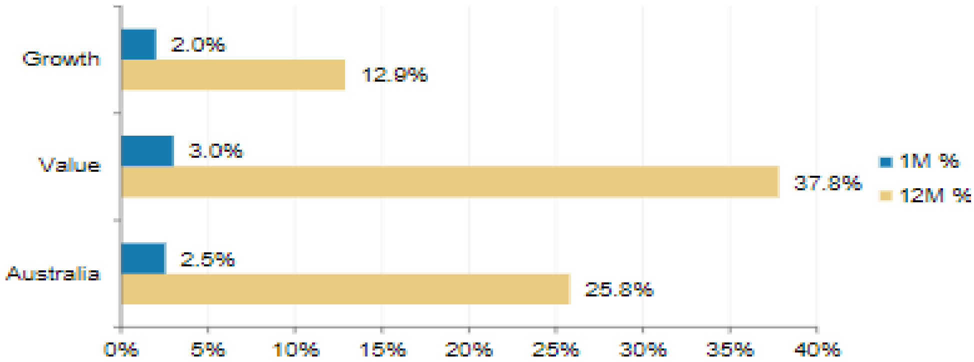
Performance	1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception (p.a.)^^
Net^	3.03%	11.37%	14.59%	28.76%	14.16%	13.11%
Benchmark*	2.34%	8.48%	11.74%	28.23%	9.38%	9.88%
Alpha	0.69%	2.89%	2.85%	0.53%	4.78%	3.23%

^ 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.

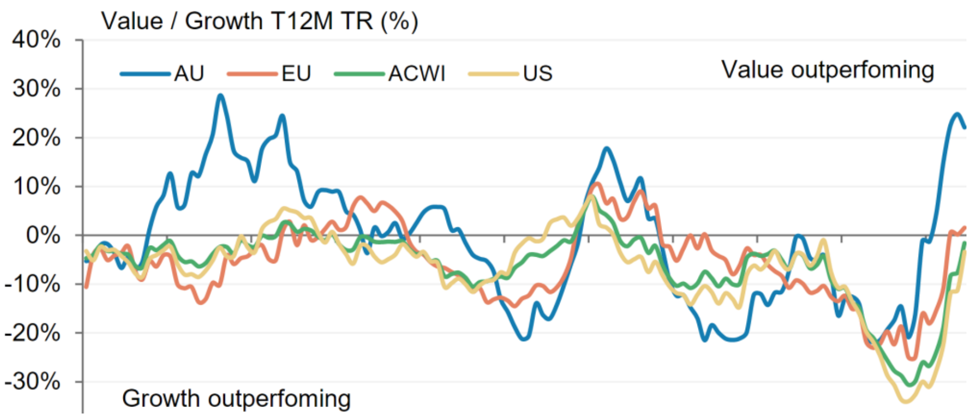
Portfolio Commentary

Global markets rose in May as vaccine roll-outs continued across multiple countries, especially in the developed world. The ASX 200 rose 2.3%, outperforming the DM World Index on the back of a strong Federal Budget and elevated commodity prices. Financials sector performance was the standout, rising 5.7%, whilst IT (Tech) was sold off aggressively, falling 9.9% for the month. Global and Australian 10 Yr bond yields continued to decline after strong rises in March (based on inflation concerns). The Australian 10 Yr bond yield retraced 6 bps to 1.63% in May. The AUDUSD rose 0.2c to $0.77 cents as commodity prices increased. Iron Ore prices surged another 7% to close at US$207.50/Mt at month end. Oil continued its strong recovery, ending the month at US$69.32/bbl whilst Gold gained 7.8% through May; the largest monthly gain since Jul-20. A key factor in the surge was the persistence of negative real rates through May, which ended the month at -0.85%.

Value stocks continue to outperform growth stocks around the globe, especially in Australia. Value has outperformed Growth materially since last November. Investors remain uncertain as to the duration of this rotational pulse but it is likely to peak when cyclical momentum in the economy peaks. The upshot of a continued higher bias in bond yields, should they continue, is higher share price valuation discount rates, which will continue to pressure asset allocation away from growth scarcity trades and long-duration positioning.



Source: RIMES, MSCI, Morgan Stanley Research.

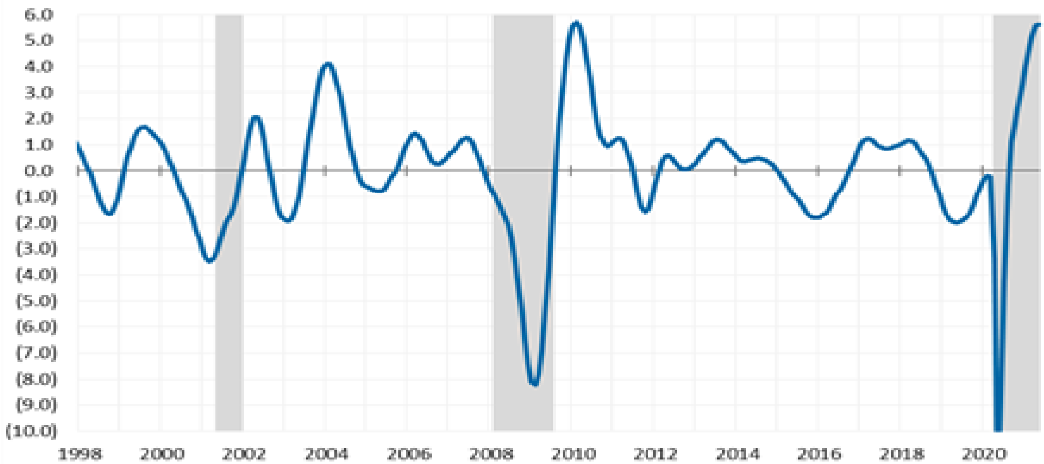


Source: Morgan Stanley.

Where are we in the cycle?

According to Macquarie Capital, when looking at important lead economic indicators, such as the OECD leading indicator, we seem to be approaching a peak in cyclical momentum. This coincides with a peak in global stimulus spending (US$30.0tn) as we begin to open up world economies post the vaccine rollout. Rising bond yields due to inflationary pressure (higher commodity, labour costs etc) are likely to result in peak earnings growth rates for global markets in 2021.

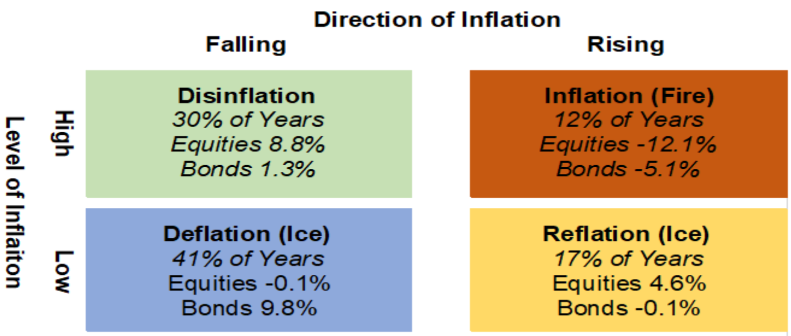
US Cycle based on the OECD Leading Indicator vs US Recessions



Source: Macquarie Capital.

Furthermore, as we move into a rising inflationary environment, returns from bonds and equities has historically been negative as share price valuation pressure and a moderation of earnings growth lead to a more challenging investment environment.

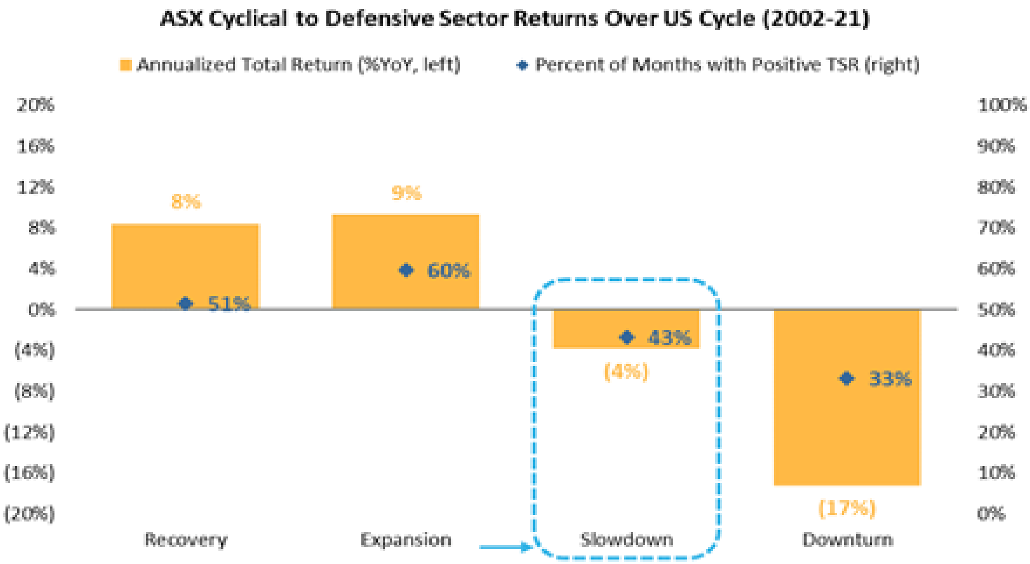
Equities & Bonds during Inflation vs Dis-Inflation



Inflation (Fire): starts with moderate inflation & ends with substantially positive inflation.
Dis-Inflation: starts with high inflation & ends with moderate inflation.
Deflation (Ice): periods starting with positive YoY inflation & ending with substantial negative YoY inflation.
Reflation: starts with negative inflation & ends with positive inflation.

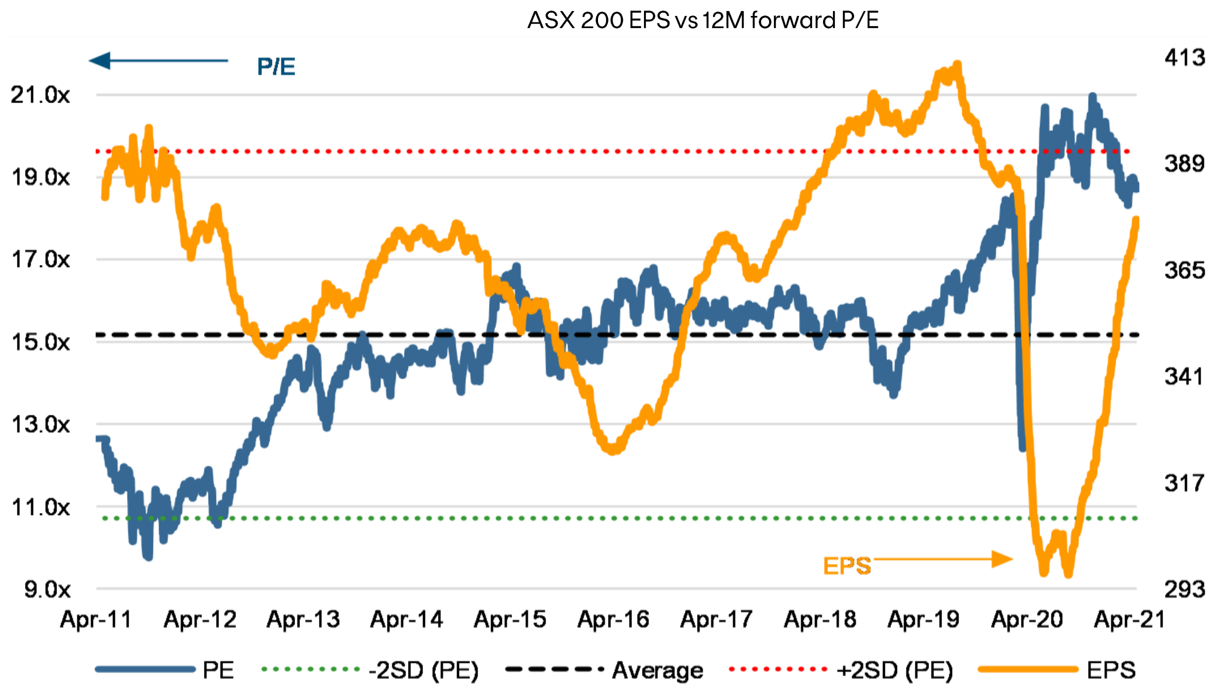
Source: Endeavour Equities.

Historically, when we see a cyclical peak in lead indicators, we shift from an expansion to slowdown phase at this stage of the economic cycle. This is important as the strongest returns for risk assets has historically been in the recovery and expansion phase. In the slowdown phase, risk appetite falls with stock leadership in the market shifting to more defensive names as earnings per share growth rates moderate. Also, while Value tends to outperform during the slowdown period, the outperformance vs Growth and Momentum is more muted.



Source: Macquarie Capital.

It must be highlighted that valuations are still looking elevated vs history, particularly against a backdrop of rising bond yields and moderating earnings growth expected in FY22.



Source: JP Morgan.

Fund Performance & Commentary

The first five months of the year have been dominated by rising economic growth forecasts, steepening yield curves, rising inflation expectations and surging commodity prices, all of which has favoured value stocks outperforming the market. We expect the period of strong outperformance by Value stocks is likely to come to an end in the next few months as we enter a more challenging period for the market. Value is still likely to outperform on a relative basis but the gap is likely to be more subdued.

For the month of May, the Fund outperformed its benchmark by 69 bps on a relative, net basis, achieving a monthly absolute return of 3.0%. The Fund has just passed the 2 year period since inception and has outperformed its benchmark by 4.78% over that time period on a net basis.

From a sector and stock perspective, relative outperformance came from Consumer Discretionary (overweight Aristocrat Leisure), Energy (Ampol) and IT (underweight Afterpay). The biggest detractor to performance was not owning Commonwealth Bank.

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. The Fund continues to position more defensively with a focus more on capital protection than growth at this stage of the cycle.

Portfolio Activity – Major Transactions

During the month, we exited James Hardie Industries on valuation grounds and concerns that the US housing cycle is in the stages of peaking. It has been a very successful investment for the Fund. We also exited Super Retail Group and Nine Entertainment on the basis of peaking earnings growth post the end of the stimulus. Again, both were successful investments for the Fund.
We predominantly added to building our defensive growth positions based on the commentary and rationale above. This included increasing our weighting in Woolworths, CSL and ASX Limited.

We also added Orora Limited into the portfolio as a more defensive, inflation hedged investment given their business mix. Orora looks attractive on valuation grounds and has begun receiving earnings upgrades over the past few months. The stock offers an attractive dividend yield in excess of 4.0% with decent dividend growth over the next two years.

Macro News

US March activity indicators were mixed. The manufacturing ISM rose to 64.7, above expectations of 61.5. Similarly, March retail sales were strong, rising 9.8% vs expectations of 5.8%, as were February housing starts. Finally, March Non-farm payrolls came in well above expectations, rising 916,000. This saw the unemployment rate fall to 6.0%. Most Importantly, March core CPI also came in well above expectations, rising 2.6% year on year. This is a key focus point for markets.

China economic data was also mixed, with the February CPI and March Caixin manufacturing PMI both coming in below expectations. Weaker Chinese data seems to be a consequence of the government cooling down the economy due to inflation fears.

In Australia, we witnessed a big Federal Budget, with nominal GDP revised up further to 3.75% in 20/21 and 3.25% in 21/22. These forecasts also assume a very conservative iron ore price of US$55/t. Peak gross debt will be seen in FY24/25 at A$1.2 tn, or 50% of GDP on the back of continued stimulus. The budget is now unlikely to be in balance until after 2025.

Australian economic data was robust with the unemployment rate falling to 5.5%, the lowest since March 2020, and capex surging to a 6.3% quarter on quarter increase. Critically, wages growth appears to be accelerating due to acute labour shortages across multiple industries. Housing prices continue to boom across the country, fuelled by record low interest rates. Sydney house prices have risen 11% over the past quarter alone.

Fund Positioning

The Fund continued to reduce its Cyclical Yield exposure and rotate more into Dividend Champions as cyclical earnings expectations are likely to see a peak in coming months and these stocks have seen a dramatic recovery in share prices, many back to all-time highs. We have moderated our overweight position in Value stocks as a result of this and have increased exposure to defensive quality stocks.

The beta of the Fund (a measure of volatility) has reduced further and now sits at 0.87 vs a market beta of 1.00. This reflects the more defensive stance we have taken in the portfolio. The expected FY 22 dividend growth rate of investee companies held within the portfolio is comfortably above that of the market, at 23.0% and 11.7% respectively. The expected dividend yield of investee companies held within the portfolio is currently 3.4%, 84% franked vs the market dividend yield of 3.7 %, 79% franked.

Portfolio Characteristics

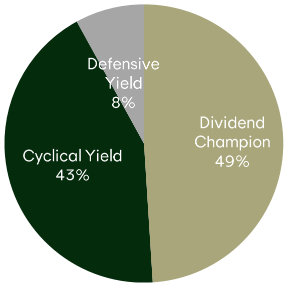
TOP 10 HOLDINGS

Westpac Banking Corporation	8.1%
Australia and New Zealand Banking Group Limited	7.7%
National Australia Bank Limited	6.4%
CSL Limited	5.2%
Aristocrat Leisure Limited	5.1%
Woolworths Group Ltd	5.0%
Tabcorp Holdings Limited	3.8%
Ampol Limited	3.6%
Rio Tinto Limited	3.6%
Sonic Healthcare Limited	3.5%

KEY PORTFOLIO METRICS

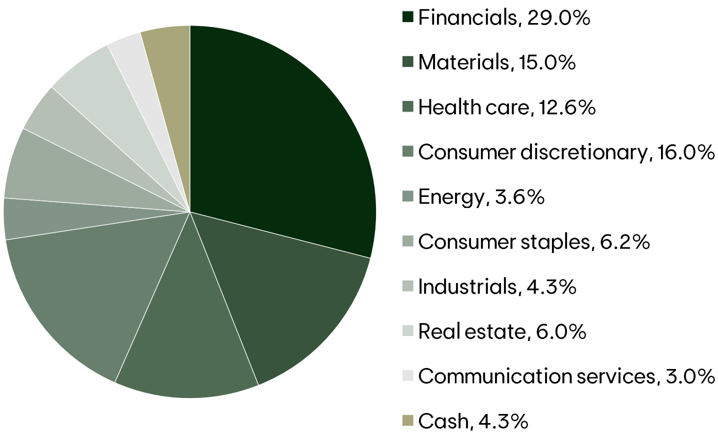
FY22(e)	Fund	Benchmark
Price/Earnings (x)	18.0	18.4
Dividend Yield (%)	3.4	3.7
Dividend Growth rate (%)	23.0	11.7
Beta	0.87	1.00

PORTFOLIO YIELD EXPOSURE



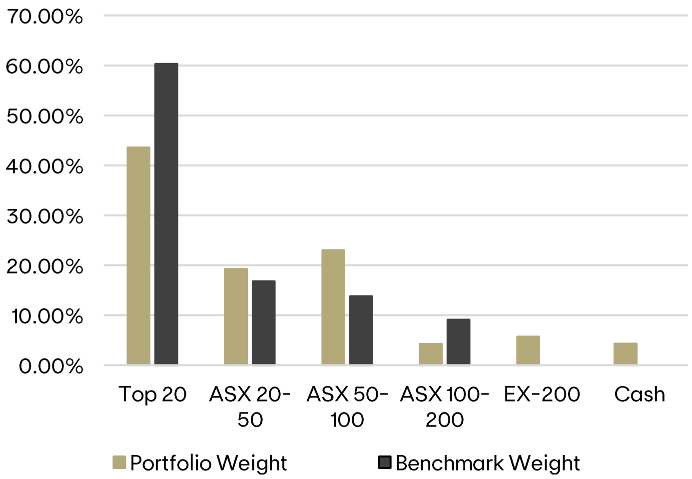
Source: Ellerston Capital.

SECTOR ALLOCATION



Source: Ellerston Capital.

MARKET CAPITALISATION



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Find out more

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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

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