Ellerston Low-Vol Income Strategy Fund

Monthly Newsletter, June 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	$1.2983
Net Asset Value	$1.2951
Redemption Price	$1.2919
Liquidity	Monthly
No Stocks	28
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^	1.96%	10.28%	17.17%	29.02%	13.59%	13.59%
Benchmark*	2.26%	8.29%	12.90%	27.80%	8.62%	10.62%
Alpha	-0.30%	1.99%	4.27%	1.22%	4.97%	2.97%

^ 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.

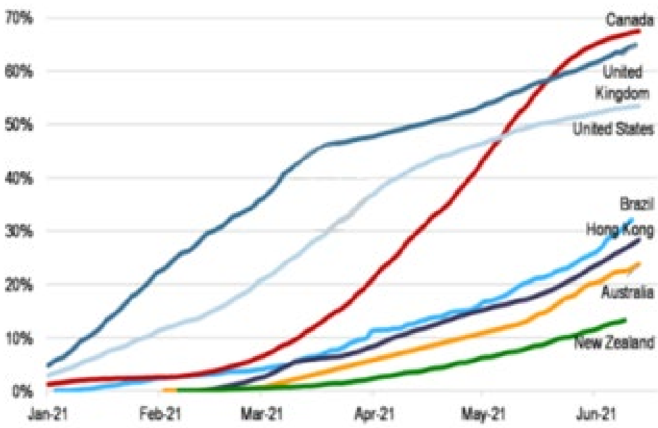
PORTFOLIO COMMENTARY

Markets

Global markets had another positive month with the MSCI World Developed Markets Index and Emerging Markets World Index both rising 1.4% in USD terms. The S&P500 was the key driver of developed market performance, rising 2.3%. In Australia, the ASX 200 outperformed key world markets, rising 2.3% in AUD terms vs 2.1% for Developed Markets in AUD terms. The ASX 200 rose 27.8% in FY 2021, the strongest performance since the 1980's. In June, growth stocks gained the performance upper hand over value stocks as bond yields retraced.

Global COVID cases passed 180.0m in June but daily numbers continued to decline despite the rise of the Delta variant. We are still witnessing the spread of the significantly more contagious Delta variant in countries such as India, Indonesia, the US and now Australia. The decrease in overall global COVID cases is a function of the continuing vaccine rollout program. More than 3.0 billion COVID vaccines have now been administered, with 23.0% of the global population having received at least one dose. The countries that have provided at least one shot of the vaccine to the largest percentage of their population include Canada (67%), Israel (56%), Italy (55%) and the US (54%). Frustratingly, only 24% of the Australian population has received at least one dose. As a consequence, the arrival of the Delta variant has seen key parts of Australia go into lockdown, costing our economy around A$1.0bn per day in lost economic activity.

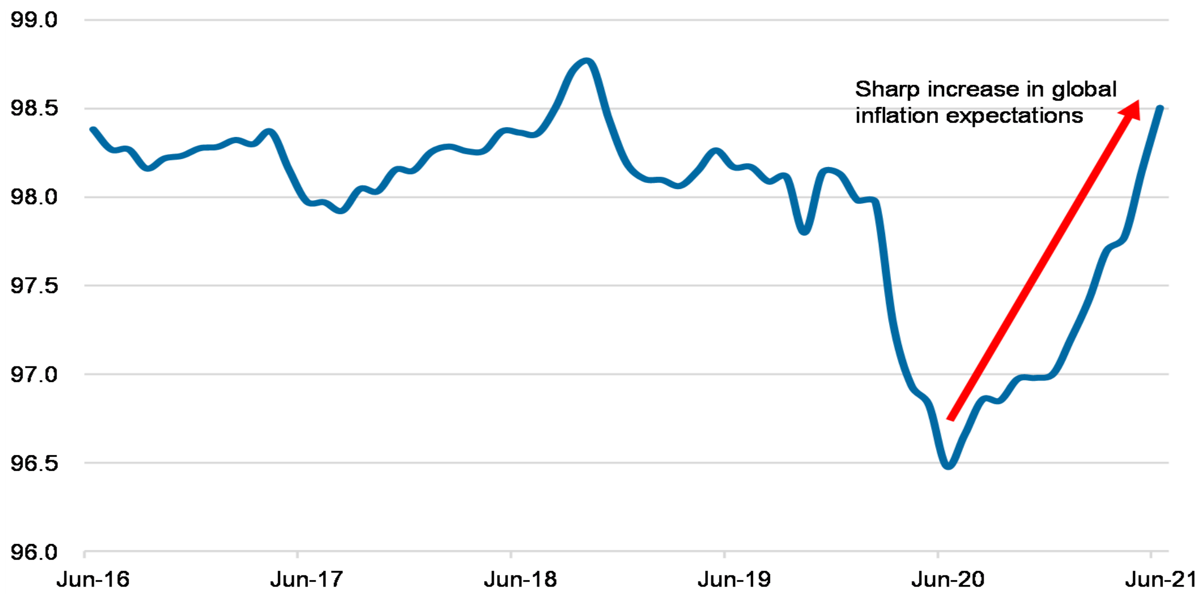
Global Inoculation Rates



Source: Our World in Data.

Reflation is well and truly under way, with inflation gauges rising across the globe. While expectations for inflation have climbed sharply in the past year, many global economists still hold the view that much of today's inflation spike will be transitory. This remains to be seen but we are likely to have a much clearer roadmap by the end of the year.

JP Morgan CPI Forecast Revision Index (global)



Source: JP Morgan.

As a consequence of the uncertainty around inflation expectations, global bond yields have recently retraced from previously elevated levels, with the US 10 year treasury yield falling 13 bps to 1.44%. Similarly, the Australian 10 year treasury yield dropped 12 bps to 1.51%.

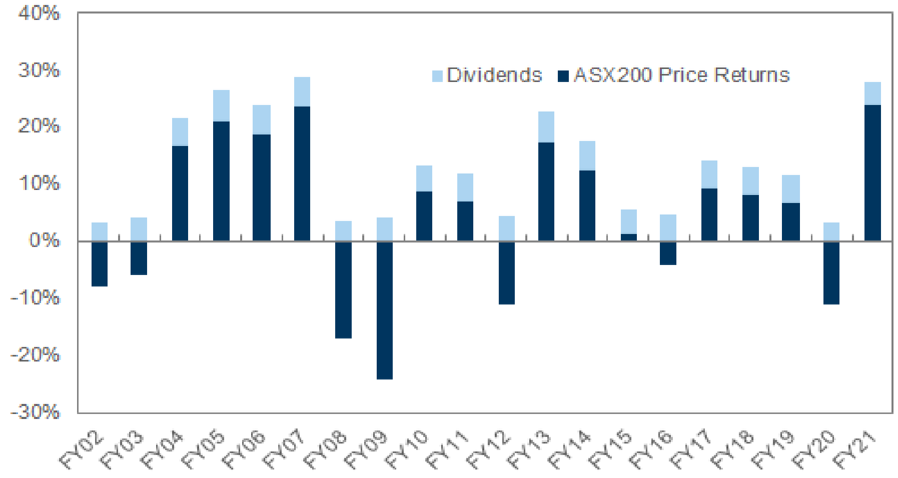
The market was already priced for two rate hikes in the U.S during 2023. However, the continuation of stronger economic data will surely see rate hike expectations brought forward. The June meeting of the Federal Reserve saw a step change in language from Jerome Powell. It now appears the Fed is not as comfortable to sit still into a red hot recovering economy, even if they regard inflation as transitory. This is very important for asset prices, especially equities, as it may mark a reversal in the very benign combination of lower real rates and higher inflation break evens, a key driver of markets.

Australian Company Earnings and Sector Performance

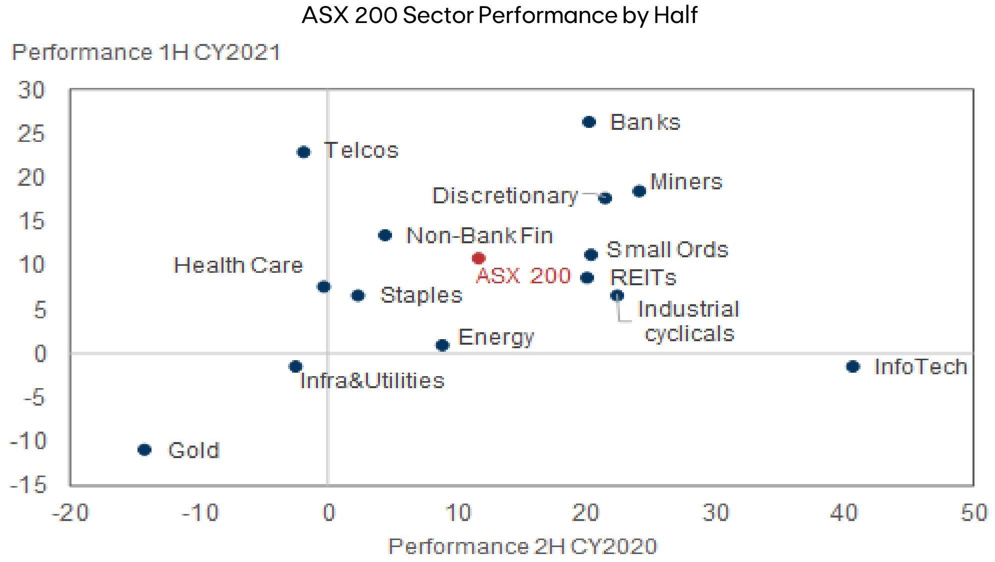
FY21 saw the Australian market return 27.8% (including dividends), making it the best performing financial period in over 30 years. Interestingly, the Australian market lagged the MSCI World Index, up 37%, despite the Australian economy contracting only 2.4% in 2020. This compared with the European and US economy declining 6.7% and 3.5% respectively.

From a sector perspective, Financials (+41%) and Materials (+35%) led the market performance resurgence amid a strong economic recovery, booming commodity prices, vaccine optimism, and reflation expectations. Discretionary Retail (+46%) performed strongly given the combination of unprecedented fiscal support to households and COVID restrictions that greatly reduced spending options. Gold (-24%) and Infra/Utilities (-19%) were the only two sectors that registered negative returns. The relatively poor performance of the Energy sector (+9%) appeared a rather striking anomaly given the strong rally in oil prices.

ASX 200 Total Returns (2002-2021)



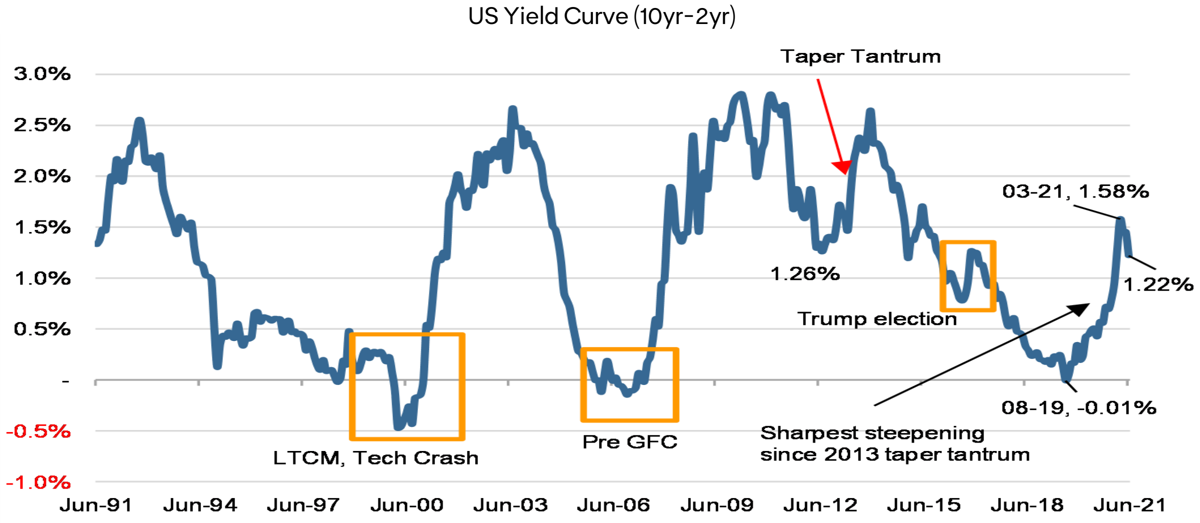
Source: Goldman Sachs Global Investment Research.



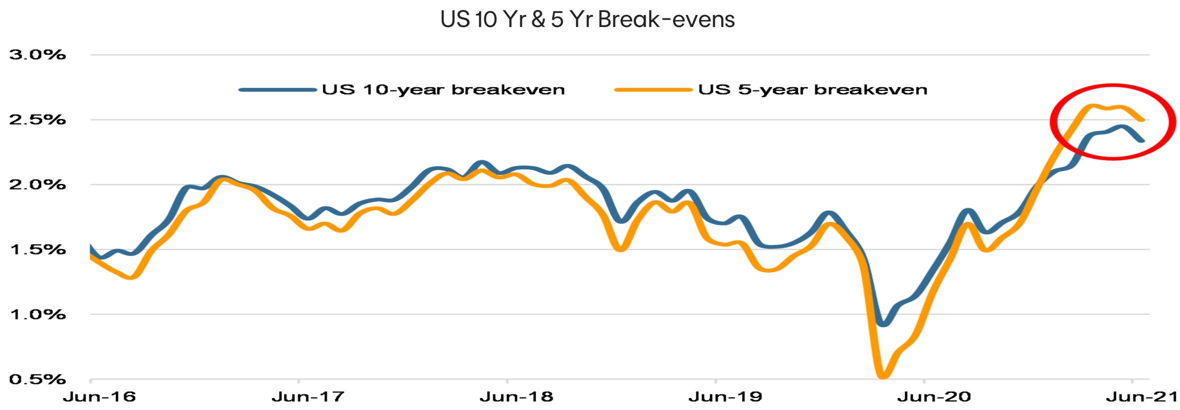
Source: Goldman Sachs Global Investment Research.

The Debate of Value vs Growth Continues

The Fed's hawkish turn last month precipitated sharp moves across the asset class spectrum. Of greatest significance was the flattening in the US yield curve, which compressed by 23bps, the sharpest compression since January 2015. The Fed's indication that tapering and ultimately tightening might be closer than previously envisaged had the desired effect on inflation expectations, with 5-year and 10-year US break-evens turning lower, albeit only moderately, through the course of June.



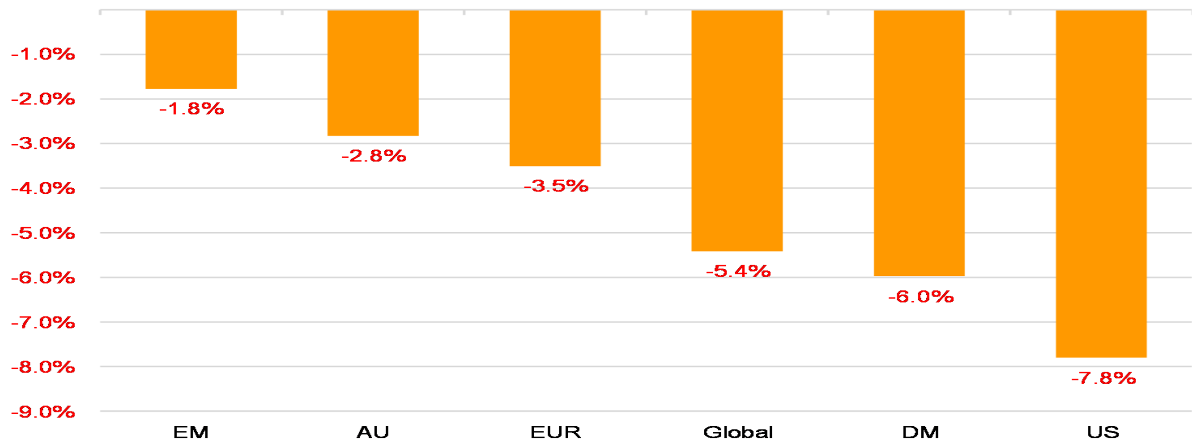
Source: JP Morgan.



Source: JP Morgan.

Equity markets saw a strong resurgence of Growth, with Value underperforming across the board. As shown in the following chart, the deepest underperformance of Value occurred in the US, where Tech leapt (+6.9%), while Financials (-3.1%) and Materials (-5.5%) lagged.

Value vs. Growth by Region during June 2021

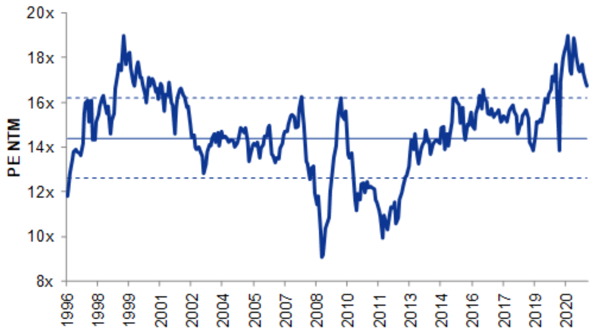


Source: JP Morgan Global Research.

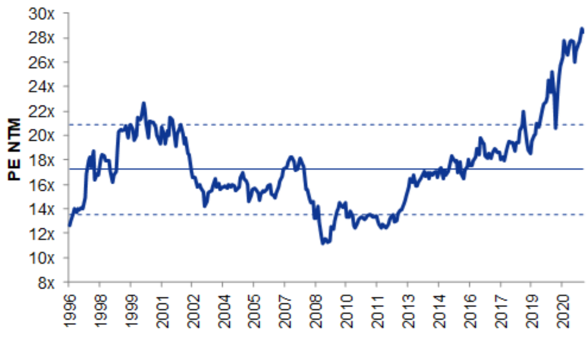
Australian Market Valuations

It must be highlighted that valuations are looking very elevated vs history, particularly against a backdrop of longer term rising bond yields and moderating earnings growth expected in FY22. Furthermore, tapering considerations by the Federal Reserve are likely to be positive for the USD, which will be a near term headwind for commodity prices, and therefore mining company earnings.

ASX 200 firms trade at an average forward PE of 16.7x, which is 16% above the 20-yr average



Industrials firms trade at an average forward PE of 28.4x, which is 65% above the 20-yr average



Source: Goldman Sachs Global Investment Research.

FUND PERFORMANCE & COMMENTARY

The first six months of the year has 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. As mentioned in last month's report, we expected the period of strong outperformance by Value stocks was 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 June, the Fund slightly underperformed its benchmark by 30 bps on a relative, net basis, achieving a monthly absolute return of 2.0%

The Fund has just past the 2 year period since inception and has outperformed its benchmark by 5.0% over that time period on a net basis. From a sector and stock perspective, relative under performance came from Materials (overweight Oz Minerals) and Financials (overweight NAB & Westpac). The biggest contributor to performance was being overweight Mineral Resources.

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 saw the addition of Endeavour Group into the portfolio post the demerger of the pub and gaming business from Woolworths. We see Endeavour Group being able to grow earnings and dividends by 6-8% p.a over the next 3-4 years as they continue their gaming machine renewal program (resulting in an expected 20% turnover uplift), coupled with the continued rollout of Dan Murphy's stores across Australia.

We also added Waypoint REIT into the portfolio as an inflation hedge play. Waypoint is Australia's largest listed REIT owning solely fuel and convenience retail properties across Australia. Given their property leases escalate at 3.0% p.a and are long term by nature, we see this investment as an inflation hedge against rising rates in the future providing a stable, growing income stream to shareholders.

We funded these purchases by reducing some of our successful positions, namely Aristocrat Leisure, Tabcorp Holdings and ANZ Banking Group, all on valuation grounds. We also divested our holding in Northern Star Resources based on our stronger USD view as tapering talk becomes more prominent. A stronger USD will weigh heavily on the gold price.

Macro News

US May economic data was strong but some activity indicators were weak. The manufacturing ISM rose to a slightly higher than expected 61.2, with the composite services ISM beating expectations with a reading of 64.0 but May non-farm payrolls coming in below expectations at 559,000. This drove the US unemployment rate down to 5.8%, a rapid decline from the 15% unemployment levels seen in the peak of the first shutdown in 2020. Finally, May core CPI rose 0.6%, resulting in a year on year rise of 5.0%, well above expectations.

China economic data continues to look a little softer as the government deliberately attempts to cool the economy down due to inflation fears. May CPI rose 1.3% vs expectations of 1.6% whilst the manufacturing PMI slightly ticked up to a reading of 50.9.

In Australia, we witnessed the role out of the State Budgets, resulting in a broad expansion of fiscal deficits as we continue to fight the economic impacts of COVID. Federal and State Budgets imply that total public capex for FY21/22 will surge by 20%.

Australian economic data was robust with the unemployment rate falling again to 5.1%, the lowest almost since 2008. The minimum wage is set to increase 2.5% from July, but staggered across industries. Retail sales lifted by a stronger than expected 1.1% in April whilst NAB business conditions surged strongly to 37.2 in May.

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) sits at 0.90 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 22.4% and 13.4% respectively. The expected dividend yield of investee companies held within the portfolio is currently 3.6%, 82% franked vs the market dividend yield of 3.9 %, 81% franked.

Portfolio Characteristics

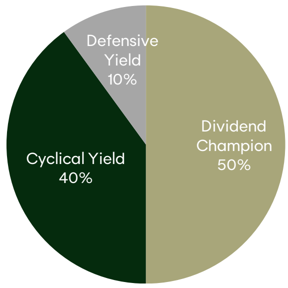
TOP 10 HOLDINGS

Westpac Banking Corporation	7.7%
National Australia Bank	7.7%
Woolworths Group	5.8%
CSL	5.0%
Australia and New Zealand bank	4.1%
Sonic Healthcare	3.8%
Rio Tinto	3.6%
Dexus	3.5%
Ampol	3.5%
Aristocrat Leisure	3.4%

KEY PORTFOLIO METRICS

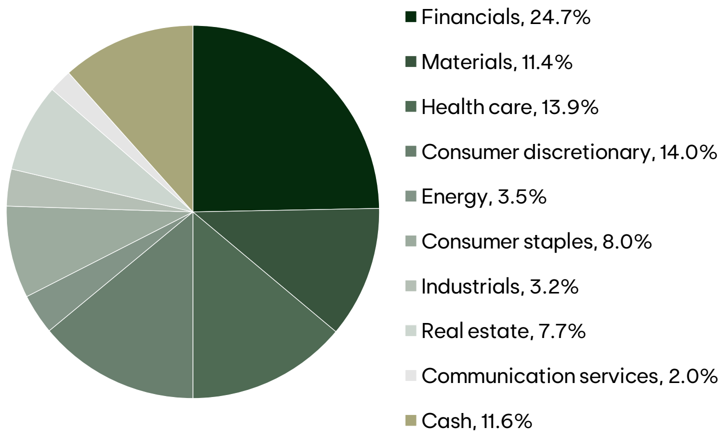
FY22(e)	Fund	Benchmark
Price/Earnings (x)	17.9	17.6
Dividend Yield (%)	3.6	3.9
Dividend Growth rate (%)	22.4	13.4
Beta	0.90	1.00

PORTFOLIO YIELD EXPOSURE



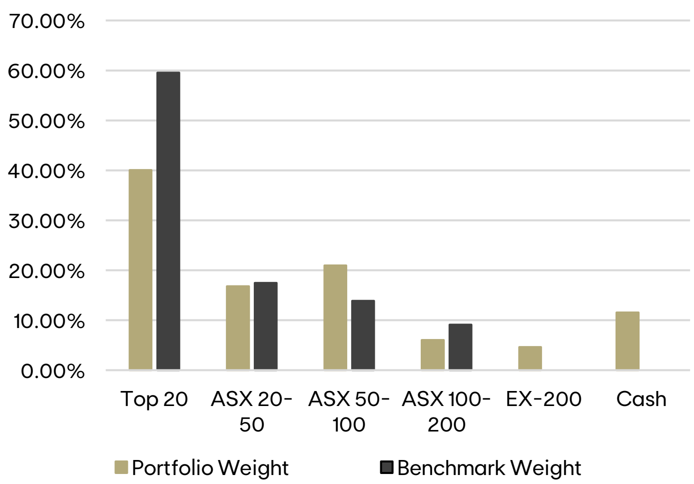
Source: Ellerston Capital.

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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