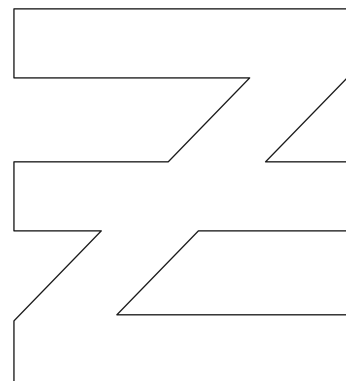


Ellerston Australian Share Fund (ASF)

Monthly Newsletter, June 2021

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

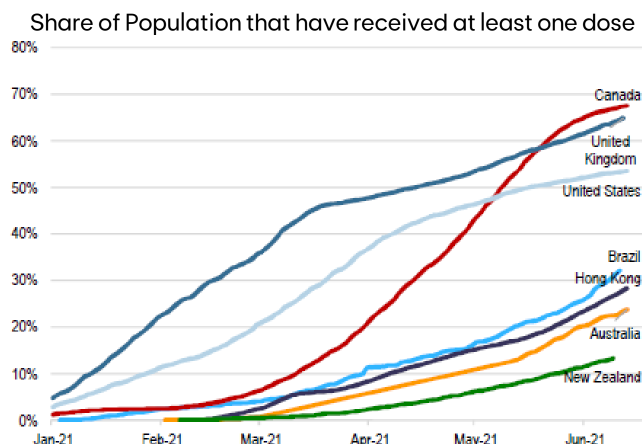
Strategy Inception*	1 April 2009
Portfolio Manager	Chris Kourtis
Application Price	$1.1180
Net Asset Value	$1.1152
Redemption Price	$1.1124
Liquidity	Daily
No Stocks	22
Management Fee	0.90% p.a.
Performance Fee	15%
Buy/Sell Spread	0.25% on application 0.25% on redemption

Net (%)	1 Month	3 Months	6 Months	FY2021	5 Years (p.a.)	10 Years (p.a.)	Since Inception (p.a)*
ASF	2.00	10.78	18.74	35.77	8.72	7.82	9.03
Benchmark	2.26	8.29	12.90	27.80	11.16	9.13	10.40

Past performance is not a reliable indicator of future performance.

MARKET OVERVIEW

Stocks notched their sixth straight monthly advance, as key data signalling prospects for a sustained rebound of the world's largest economy, outweighed inflation worries as reflected by the pullback in global and Australian 10 year bond yields. Also, global vaccination rates have allowed a number of major economies to get back to a semblance of normality, or are about to. Overall global cases have now passed 181m in June, with the US still leading at 34.5m, closely followed by India at 30.4m cases. Daily case numbers have slowed significantly from 470,000 in May to 318,000 in June, a function of continuing vaccine roll-outs. The recent national lockdown in Australia, with the exception of Victoria (for a change), highlights that getting vaccination levels to the majority of the population is a necessary precursor for sustained economic growth.



Source: JP Morgan.

USA

Federal Reserve officials signalled that the pace of the U.S. economic recovery from the pandemic is bringing forward their expectations for how quickly they will reduce policy support. Chair, Jerome Powell told a press conference that officials had begun a discussion about scaling back bond purchases after releasing forecasts that showed they anticipate two interest-rate increases by the end of 2023, projecting a faster-than-anticipated pace of tightening. The Fed's hawkish turn in mid-June seemed to wrong-foot and confuse market observers.

The S&P 500 ended at a record monthly close and its fifth monthly increase in a row, helped by a tentative deal reached on Biden's US $579bn infrastructure plan, alongside banks clearing the Fed's stress tests. The Dow Jones Industrial Index ended the month flat, the S&P 500 was up 2.3% and the Nasdaq Composite Index was up strongly at +5.5%, after being slightly down the previous month. Despite the strong economic data, US bond yields pulled back, spurring a rally in growth stocks, embracing the Fed's "transitory inflation" view, with the US 10-year bond yield falling to 1.45% from 1.58%.

Europe

European markets continued their upward momentum, buoyed by supportive growth indicators. On the data front, Euro zone business accelerated to its fastest pace in 15 years in June, with the IHS Flash PMI up to 59.2 from 57.1 the month prior. In other news, BoE's Haldane commented that he expects inflation to be "nearer 4% than 3%".

The G7 nations also agreed on global tax reform by backing the US's approval to set the minimum corporate tax rate of 15%, to ensure fairness for working and middle class people.

The Euro STOXX 50 Index finished the month up 0.7%. Among the major exchanges, France's CAC 40 was up 1.2%, whilst Germany's DAX closed up 0.7%. The UK's FTSE 100 was the laggard, up 0.4%.

Asia

China's producer price gauge surged, stoking fears that the country is both succumbing to global inflationary pressures and stirring them up. In May, the Producer Price Index leapt 9.0%, its biggest year-on-year jump since early 2008. Such fears however, appear misplaced, since China does not face the kind of bottleneck problems blighting the supply-side of the US economy. The PPI spike is less a reflection of broad producer price rises than narrow oil and steel price volatility. Outside of the commodity complex, upward price pressure is far less intense and consumer price inflation is pretty muted. China's trade surplus in May rose to US$45.5bn, below consensus, but above the previous print of US42.9bn.

Asian equity markets were mixed. The Hang Seng Index was down -0.7%, Korea's KOPSI delivered a strong positive return of 2.9%, and the Nikkei 225 was down 0.1%. The broader Chinese SSE Index was weaker after the previous month's very strong return, closing down 0.9%, despite manufacturing data indicating the economy was stabilising at a strong pace.

Commodities

The Iron Ore benchmark price stayed close to its record high of US$238 (A$304) per tonne and closed at US$214 per tonne, 7.5% higher than May. The Brent oil price surged 8% to US$75 per barrel, reaching its highest level since October 2018 on stronger demand, signs the Iranian nuclear deal had been delayed and expectations OPEC would remain disciplined and stick to its previously stated production increases. Gold retreated back to where it was a month earlier, down 7.2% from US$1907 to US$1,770 per ounce, on receding inflationary expectations and as the US dollar rose 2.5%, following two months of decline. This was the largest monthly decline for bullion in the past 4.5 years. Base metals were mixed with copper prices down 9%, but aluminium and nickel prices up 2% and 1% respectively.

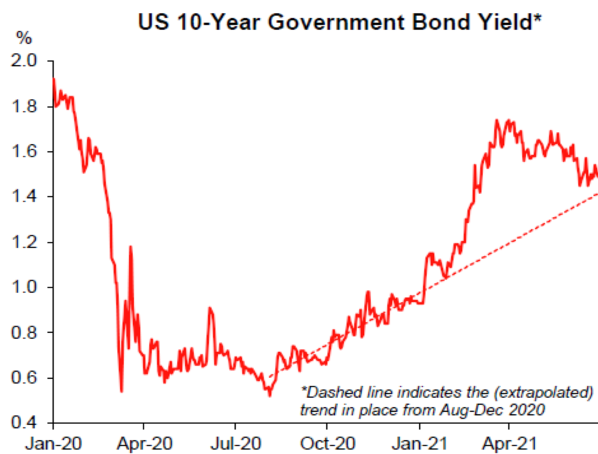
Record Iron Ore Benchmark Price in US$ and A$ per tonne

Source: UBS.

Bonds

Global bond markets rallied despite the US Federal Reserve's more hawkish stance on interest rate rises in 2023 in response to stronger economic data, perplexing investors. The US 10-year government bond yield fell 13 bps to 1.45% and the Australian 10-year bond followed the US, which saw a 12 point decline to 1.51%.

Rather than pricing significant inflation, long nominal yields have fallen. While early signs that the Federal Reserve is alert to the inflation risk, so far the moves have been minimal and siding with the 'transitory inflation" view.



Source: Macquarie Research.

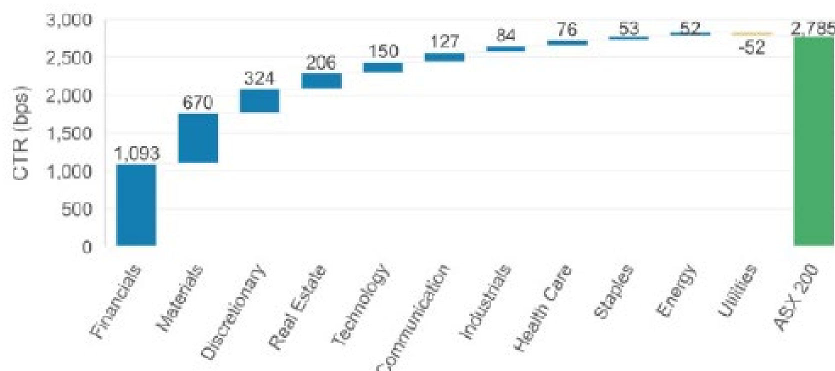
Australia

The Australian equity market in FY21 closed 73 points under its recent 7,386 all-time high printed mid-June, recording an astonishing +27.8% return and delivering its best year since 1987. The market printed 11 out of 12 positive months - this has never happened before (with the only drawdown occurring in the month of September 2020, down 4.0%). Key investment topics that dominated FY21 featured inflation (transitory or not), tapering, value vs. growth and when will the Tech rally end, if ever.

The market performance surprised most observers by rebounding strongly from the depths of 23rd March 2020 pandemic lows, propped by unprecedented Central Bank stimulus, massive Government spending and spurred on by a V-shaped earnings recovery, upbeat forward looking forecasts and capital raisings that quickly repaired pandemic induced stretched balance sheets.

Nearly all sectors posted gains of >25%, with the laggards being Healthcare (+6.2%) and Consumer Staples (+8.1%). The Utilities sector (led down by AGL and Origin), was awarded the wooden spoon -18.6% in FY21. Consumer Discretionary, Financials and IT led the charge, up 46.1%, 40.6% and 39.8% respectively.

The Barbell of Financials and Materials contributed 63% of Total Returns in FY21



Source: Morgan Stanley Research.

The ASX 200 winners' board was littered with the Small/Mid cap resource stocks Chalice Mining came in first place delivering a +646% return, closely followed by Pilbara Minerals +523% and rare earths producer Lynas +199%.

There was a wide dispersion of returns in the Top 20 performers. Afterpay was the best performing leader, ending the financial year +94% but only a whisker ahead of iron ore producer Fortescue +90% and Aristocrat +70%. The Big 4 Retail banks made a significant contribution to the overall market performance, with CBA, WBC, NAB and ANZ all chalking up returns of 44% plus. Disappointingly, previous market darlings CSL and Transurban significantly lagged. This is the first year in nearly a decade that the Healthcare sector has underperformed the broader market.

Conversely a2 Milk (A2M), which closed at $6.00, was the worst performing stock for this year, down 68% after the Chinese literally overnight just stopped buying their products. Former market darling Appen (APX, -59.7%) also collapsed after delivering three profit downgrades in succession. Small gold miners Regis Resources (RRL-52%) and St Barbara (SBM -44%) fell out of favour, while AGL used the last day of the year to outline their demerger proposal which saw another -10% wiped off its market cap to rub salt in the wound, closing the FY down -48%.

The Australian labour market rebounded strongly, with May employment surging (115k jobs added), with the majority (98k) of these being full time, causing the unemployment rate to drop sharply to 5.1% - remarkably only 0.2% above the lowest level since 2008. This comes after a decline in employment the previous month (-31k), mostly associated with the completion of the Jobkeeper wage subsidy. The strong recovery indicates those losses were temporary and absorbed by the very strong labour demand from corporates. Employment is now 1.2% above its Dec-19 levels, with total hours worked 1.8% above.

For the month of June, the S&P/ASX200 Accumulation Index rose 2.26%, marking its ninth consecutive monthly gain. The Information Technology sector (up 13.4%, led by Afterpay), was the most significant contributor to the Index's performance, adding 49 basis points, followed by Consumer Discretionary, contributing 35 basis points and Real Estate contributing 32 basis points. The bottom three contributing sectors were Financials (-6 points), Utilities (+5 points) and Materials (+9 points).

The best performing sub-index was the ASX 200 A-REIT Index up 5.5%, followed by the ASX 200 Industrials Index up 2.7%, with the underperformer being the ASX 200 Resources Index, up 0.4%.

Conversely, the top five stocks that detracted from the Index's performance were: Newcrest Mining (-12 points), NAB (-12 points), CSL (-12 points), Westpac (-11 points), and Northern Star (-11 points).

The top five stocks that made a positive contribution to the Index's return were: Afterpay (+29 points), Wesfarmers (+20 points), Woolworths (+16 points), Goodman Group (+16 points) and Telstra (+14 points).

For the month, the **S&P/ASX Small Ordinaries gained 3.08%, outperforming the broader index**, led by Telix Pharmaceticals (+35%), after announcing its first patient had been dosed in its Phase 1 clinical study and Marley Spoon (+29%), as COVID restrictions and lockdowns were imposed across Australia.

The AUD was weaker at 75 US cents, given Fed commentary becoming more hawkish and commensurate US dollar strength. Business conditions in Australia reached record highs with the release of the NAB Business Survey, showing profitability, employment and trading sub-components all outstripping previous highs. As expected, the RBA left its policy settings unchanged.

COMPANY SPECIFIC NEWS

The Market Hits

Altium (ALU +29.8%)

On June 7th, US supplier of software and multimedia tool company, Autodesk confirmed that it had submitted a proposal to acquire ALU, a provider of printed circuit board software (founded in Australia in 1985 and headquartered in San Diego) for $38.50 per share. This represented a 42% premium over the previous closing price and a 47% premium to the one-month VWAP, implying a total consideration of ~US$3.8bn. Autodesk, capitalised at US$65.5bn was to fund its offer through a combination of cash on hand and debt financing. The price implied ~50x FY22 EV/ EBITDA vs. ~30x 12-month forward rolling average multiple over the past 5 years. The proposal had apparently followed strategic partnership talks between the two companies and was immediately rejected by Altium's board, which viewed the bid as "significantly" undervaluing its PCB design and Nexar cloud platform potential. The board also noted that it would continue to engage with interested parties at more "appropriate" valuations. Not surprisingly, the share price shot up, despite a minor profit downgrade delivered mid-month when the company hosted a short investor day and provided a trading update ahead of their FY21 result in August, citing revenue to be at the lower end of its guidance of US190-195m.

Afterpay (APT +27.4%)

The stock bounced back in June as lower bond rates benefitted longer dated growth stocks such as APT. In addition, APT announced it will enable one-time card purchases to select customers in the US at a range of large merchants which collectively drive almost half of US e-commerce volumes. Customers will be able to use this functionality via using the Afterpay Shop Directory, where APT will automatically populate payment details at the checkout with a single-use prepaid card. Merchant availability includes Amazon, CVS, Dell, Kroger, Macy's, Nike, Sephora, Target, Victoria's Secret, Walgreens and Yeti. Revenues are generated by affiliate fees and no direct merchant integrations are required. This increases the total addressable market and potentially APT's take rate to which investors reacted positively. For APT, the implications of this development for relationships with existing merchants that have supported APT's development is unclear i.e. they have used existing merchants to acquire customers, and is now leveraging those customers to drive sales for competitors.

Pro Medicus (PME +27.3%)

Radiology software company, PME's share price rally has been largely driven by several high profile contract wins, most recently a $14m 8-year contract with the University of Vermont health network. The company runs a lean cost structure - their EBITDA margin on incremental revenue is approximately 80% - making profit forecasts exceedingly sensitive to the timing of new contract signings. FY21 has been a record year for new PME contracts. This acceleration, paired with a shift in industry dynamics to preventative healthcare and early disease detection (demanding larger file sizes), supports PME's positive outlook and foray into the $2bn per year Picture Archiving and Communications market.

Whitehaven Coal (WHC +23.2%)

WHC spiked as spot thermal coal prices continued to climb, up a further 10% in June, as strong Chinese demand and supply issues with Mongolia and Indonesia continue. During the month, WHC downgraded their Narrabri mine's production by 3%, the second downgrade in two months on yet another geological event. Narrabri only accounts for ~20% of total production so the higher coal prices were the main focus for investors.

Megaport (MP1 +22.9%)

A combination of factors pushed MP1's price higher: A market update on its new product Megaport Virtual Edge early in the month, a strong tech market (Nasdaq up 5.5% in June), two large brokers upgrading to buy recommendations and as a result, a bout of short covering.

ResMed (RMD +20.8%)

It has been a perfect storm for RMD as the pending launch of their highly anticipated Airsense11 device has coincided with a major product recall from one of their largest competitors, Philips Respironics. Following Philips initial recall notice in April of the DreamStation1, the company doubled their provision to €500m in June to accelerate the repair and replacement program, following the damaging risks stemming from the disintegration of the polyurethane sound abatement foam in products spanning back to 2009. Not only does it provide an opportunity for RMD to capture further market share and boost their margins through increased sales, but the serious health risks that the affected Philips products pose leads to reputational damage, all which bodes well for RMD.

IRESS (IRE +20.8%)

Midway through the month, IRE provided an update on the Board's plans to accelerate its EPS growth, capital management and divestment plans of its Mortgage Sales & Origination (MSO) business. MSO accounts for ~30% of all UK mortgages and is the largest provider for Tier 2 UK lenders. The timing of the announcement was interesting and immediately followed recent media reports that Private Equity was rumoured to be seeking to buy a 10% strategic interest in the company at $13-14 per share, causing a 20% spike in the stock price. However, the update seemed to make sense if IRE genuinely believes it is materially undervalued and at risk of an opportunistic bidding process. The obvious five categories of interested parties in MSO would range from UK banks, software firms, BPO providers, IT consultancies and PE. Either way, investors were left pondering whether the stock was in play.

TPG Telecom (TPG +20.2%)

The NBN issued a discussion paper suggesting that the CVC charge could be replaced by a flat rate pricing model. As TPG is less advanced in the roll out of its 5G network, it would be best placed amongst the major telcos to benefit from any reduction in the cost to access the NBN capacity. TPG was removed from the S&P/ASX100 benchmark in June and became a major index position in the ASX Small Ordinaries, which combined with the NBN announcement was enough to get small cap investors to jump on board.

Brickworks (BKW +19.8%)

BKW ran hard after a positive trading update, with expected Building Products earnings before interest and tax ("EBIT") to be higher in both Australia and North America for FY21. Sales were gathering momentum and more importantly, record Property underlying EBIT of $240-260 million for FY2021, up from $129 million in the prior year, boosted investor confidence.

Iluka Resources (ILU +18.5%)

ILU was up 12% on the last day of the month after Rio Tinto announced the curtailment of operations at Richards Bay Minerals (RBM) in South Africa. This followed an alarming escalation of violence there in recent weeks, with all mining and smelting operations halted and force majeure declared. RBM has been operating at around 50% of nameplate capacity, but still produces around 10% of global zircon and titanium dioxide (TiO_2) feedstock supply. A prolonged outage would be very positive for pricing and ILU profitability.

The Market Misses

Nuix (NXL -20.2%)

NXL, the software company specialising in intelligence solutions, was down again, only this time there wasn't a fifth downgrade but rather regulatory actions. Explosive insider trading claims were made by the corporate regulator, ASIC against the former CFO of realising $17.8 million from alleged insider trading after helping to release a prospectus for the tech company's December IPO, that ASIC claim was false and misleading. Earlier in the month, the Australian Federal Police confirmed that it was investigating issues regarding the Corporations Act in relation to Nuix's former chairman, and later raided NXL offices. The focus of the investigation is a package of options issued to the former chairman which he cashed out for $80 million in Nuix's float. Sadly, this is not the plot of a Guy Ritchie movie, but the lesson for investors is more akin to an Aesop's fable.

Gold Road Resources (GOR -18.5%) / Westgold Resources (WGX -17.5%) / Silver Lake Resources (SLR -17.4%) / Evolution Mining (EVN -16.8%) / Northern Star (NST -16.4%) / Ramelius Resources (RMS -14.0%) / Regis Resources (RRL -10.9%)

After May's strong +10% gold sector performance which was in line with the rise in bullion prices, the reverse occurred in June. Gold fell 7% as the US dollar changed course and rose 2.5%, resulting in the gold sector falling 12% for the month.

Chalice Mining (CHN -15.5% / OZ Minerals (OZL -11.1%)

Both of these polymetallic mining stocks were impacted by the fall in gold prices, but more so the 9% fall in copper prices from recent highs of over US$10,000/t during the month. Moves by Chinese authorities to release metals from their strategic stockpiles weighed on base metal prices, especially copper.

FUND PERFORMANCE

FINANCIAL YEAR IN REVIEW

The month of June confounded investors. The Fed's more hawkish overtures and intention to raise interest rates signalled at its June meeting, perversely drove global and Australian bond yields lower, sparking an IT and growth rally domestically. The IT sector, up 13.4% and growth surge, was led by the likes of Altium, Afterpay, Pro Medicus, Megaport and Iress, all of which gained 20% plus. Financials lagged, just as many Johnny come lately investors piled into the sector in the past few months after its massive run over the past 9 periods on the FOMO factor.

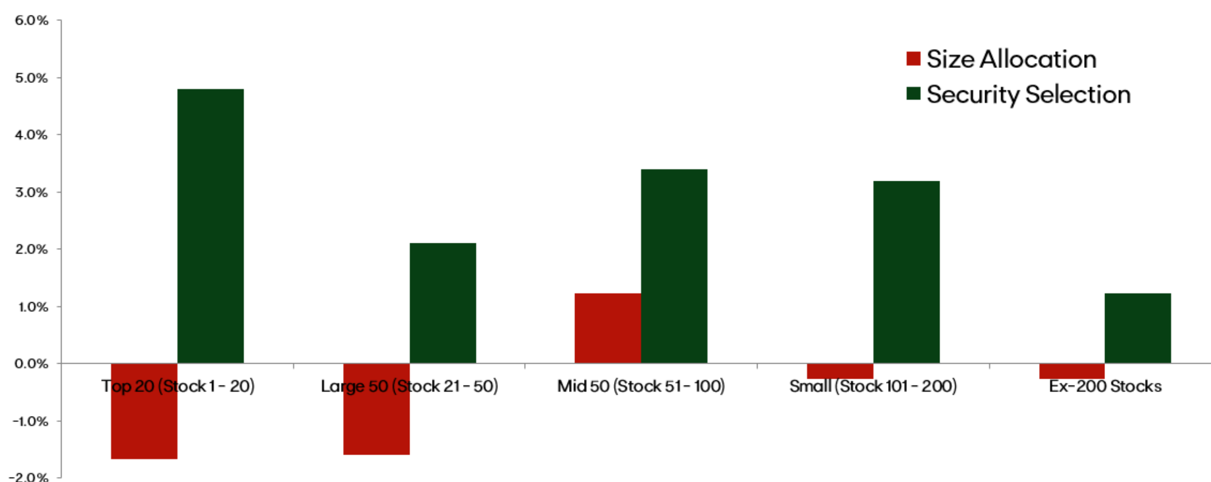
Despite this restless rotation back into growth, for the month of June the Fund returned 2.10%, broadly tracking the benchmark return of 2.26%.

This result caps off a very satisfying FY21 for our strategy and we are delighted to report that the Fund's return of 37.26%, was the highest yearly return since inception.

The 2021 Financial Year turned out to be an extraordinary year by any measure. A pandemic induced global recession, unprecedented Government and Central Bank stimulatory actions, turbulent geo-politics (culminating in a Biden Democratic election victory full of thrills and spills) and ultimately, the sharpest V-shaped economic and earnings recovery in living history.

Throughout the journey, we remained true to label and true to our high conviction, benchmark unaware stock picking approach, generating alpha from stock selection across all the size sub-segments of the market (refer chart below).

Attribution: 30 June 2020 to 30 June 2021
Alpha Generated From Stock Selection Across all Segments



Source: Ellerston Capital.

Having been significantly underweight the Financial and Banking sector for the right reasons for many years (and being critiqued for the past 5 years), we selectively pivoted back into the Banks in a big way in late 2020 and moved overweight. The strategy proved highly fruitful and large overweight's in ANZ and WBC contributed significantly to the Fund's performance (WBC has in fact been the best performing big bank CYTD, up 36%). **Towards the end of the financial year, we exited ANZ, locking in profits and moved underweight the sector again.**

The Fund moves overweight in December quarter 2020.

Source: Bloomberg.

Capturing the cyclical recovery and re-opening trade rebound in share prices, the likes of Reliance Worldwide, Fletcher Building, Downer, Flight Centre and James Hardie also helped performance, as did overweight positions in gaming stocks Aristocrat Leisure and Tabcorp.

We made some focused changes to the Fund in the June quarter of 2021, deliberately rotating into high quality, industrial defensive businesses (such as ResMed, CSL and Carsales.com), all of which had underperformed since the pandemic, yet have strong competitive advantages - this rotation and strategy at a key inflection point, just before the Fed signalled its intentions to raise rates, also proved fruitful. ResMed returned 20.8% in the month of June alone (refer Market Hits commentary).

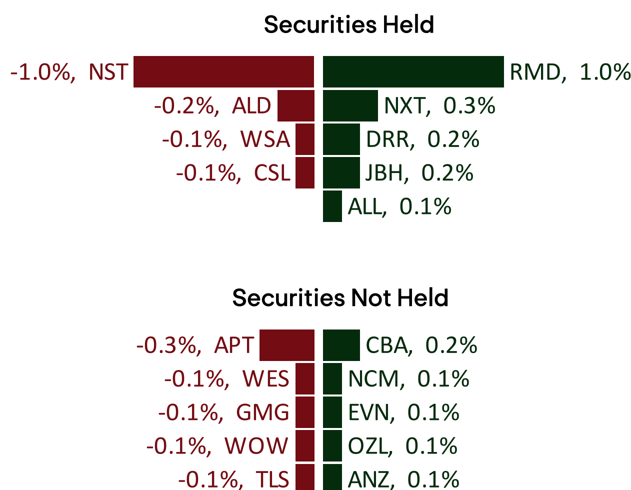
A pleasing highlight of the year was our **renewed vigour pertaining to risk management screening and retesting our investment thesis on stocks, which meant we avoided the blow ups** that have littered the funds management landscape: A2 Milk -68%, Appen -60%, AGL -48%, Mesoblast -39% AMP -35% and a plethora of new IPOs which sank like a stone from their issue prices, namely Cleanspace Holdings -65%, Nuix -56%, Adore Beauty -37%, Dalrymple Bay -18%, Australian Clinical Labs -15%, Latitude Group -12% and Pepper Money -9%. This is by no means an exhaustive list. We also held no stocks in the worst performing sector, Utilities -18.6% in a market up 27.8%.

Our underweight exposure to key leading iron-ore producers was the single biggest detractor to the Fund's performance for the Financial Year (zero holding in BHP, RIO, FMG and MIN) which cost the Fund ~ 2% of lost performance. We remain of the view that iron-ore prices at US$217/t at time of writing are unsustainable (we said that at US $150/t as well...), but have been wrong thus far. We are sticking to our guns.

Returns[1] (%)	*Gross*	*Benchmark**	*Excess*	*Net*
1 Month	2.10	2.26	-0.16	2.0
3 Months	11.07	8.29	2.78	10.78
6 Months	19.38	12.90	6.48	18.74
FY2021	37.26	27.80	9.46	35.77
5 Years (p.a.)	9.89	11.16	-1.27	8.72
10 Years (p.a.)	8.97	9.13	-0.16	7.82
Since Inception (p.a.)	10.21	10.40	-0.19	9.03

Past performance is not a reliable indicator of future performance.

Month of June Attribution



Source: Ellerston Capital.

The main positive contributors to this month's performance were overweight positions in: Resmed (RMD +21.4%), NEXTDC (NXT +10.1%), Deterra Royalties (DRR +7.1%) JB-HiFi (JBH +4.0%) and Aristocrat (ALL +5.1%).

Zero weight positions that also helped included Commonwealth Bank (CBA +0.2%), Newcrest Mining (NCM -10.7%), Evolution Mining (EVN -16.8%) Oz Minerals (OZL -11.1%) and ANZ Bank (ANZ -1.4%).

The main detractors to performance for the month were overweight holdings in: Northern Star Resources (NST -16.7%), Ampol Limited (ALD -1.2%), Western Areas (WSA -2.0%) and CSL Limited (CSL -1.7%).

Not holding a number of larger cap shares that outperformed the broader market and somewhat constrained returns included: Afterpay (APT +27.4%), Wesfarmers (WES +6.7%), Goodman Group (GMG +9.7%), Woolworths (WOW +6.2%) and Telstra (TLS +6.8%).

[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 June, the Fund was again highly active, locking in some returns in stocks that have significantly outperformed, exiting ANZ (the best performing bank in FY21), right sizing other profitable positions (namely Aristocrat, Carsales, Graincorp, Nextdc, Resmed and Tabcorp) and strengthening other key holdings (JB Hi-Fi, Janus Henderson and Paladin).

We introduced **Link Administration, Suncorp** and **29Metals** to the portfolio, see detailed write-ups below.

NEW STOCKS ADDED	STOCKS EXITED
• Suncorp	• ANZ
• Link Administration	• Nufarm
• 29Metals	• Tabcorp (small residual holding remains)
INCREASED	**DECREASED**
• JB Hi-Fi	• Aristocrat Leisure
• Janus Henderson Group	• Carsales.com
• Paladin Energy	• Graincorp
	• NEXTDC
	• Resmed

Link Administration Holdings (LNK)

Having totally exited LNK at prices ranging from $7.10 to $8.90 way back in February to December 2018, LNK was reintroduced to the portfolio at ~$5.00. LNK is a leading provider of outsourced administration services to the superfund industry and oversees a number of core platform businesses themed around simplifying the administration of financial services through technology - over 80% of its revenue stream is recurring in nature. Link is attractively priced ex-PEXA and being selectively contrarian, in the fullness of time, we think there is significant share price upside to be unlocked.

Private equity (in the form of a consortium bid by Carlyle Group and Pacific Equity Partners) and SS&C Technology had previously bid $5.40 and $5.65 cash per LNK share respectively in late 2020, to no avail, due to the Board rejecting the proposals after considering they "significantly undervalued Link Group's business, including the PEXA asset".

What's changed?

LNK provided an update on its IPO of PEXA (the electronic conveyancing platform), which handles 80% of all property transactions in Australia, suggesting an even higher valuation than the recent KKR bid lobbed in late May. LNK announced that following a cornerstone book-build process, it had signed an underwriting agreement for the IPO of PEXA, thus rejecting the KKR / Domain $3.126bn bid which lapsed on 30 May 2021. The EV implied in the IPO is now $3.3bn (book value for 100% was ~$1.6bn on LNK's balance sheet) representing an increase of 70% on the private equity consortium's implied valuation of PEXA at $1.95bn. LNK's shareholding was to increase marginally from 44% to 47%, with LNK receiving a minimum of $50m in cash as a result of the IPO process, plus any funds received through the scale back process.

The market had been led to believe that the Board was looking at a trade sale and / or IPO of its stake (potentially unlocking a capital return for existing shareholders) and instead, LNK has intended to increase its stake. This action had clearly disappointed a few long suffering investors, who voted with their feet and dumped the stock, providing us the liquidity and buying opportunity to establish a reasonable new position at depressed prices. On the last day of the month, LNK CEO Vivek Bhatia confirmed its shareholding in PEXA by announcing that as a result of scale back allocations, Link Group will hold 42.8% and more importantly, will receive $180m of net cash proceeds, applied against debt in the first instance and providing further balance sheet flexibility.

Not surprisingly, FY21 has been a difficult year for the company. This is due to obvious headwinds, such as Brexit acting as a drag on loan management (BCM), account losses in the U.K. LMS division, perceived Woodford-related litigation risks in the UK and the Protecting Your Super Budget changes (low balance and inactive accounts being automatically swept through to the ATO) introduced in 1st July 2019, all negatively impacted revenue.

All these drivers are well known and have caused the shares to dramatically underperform. That said, there is light at the end of the tunnel from cost-out offsets and PEXA being valued far higher than previous market valuations. On an underlying basis, we see LNK as a steady business with a recurring, but modest revenue growth outlook. Management recently highlighted that FY21 financial performance and achievement of outcomes from its Global Transformation cost out target of $75m of annualized benefits (upped from $50m) was in line with expectations. At its 1H21 update, management also reinforced that FY21 was to be a base year, with growth across its business units expected from FY22. Some positives are coming through. LNK has recently re-signed some key large industry funds for the next 5 years in its Retirement and Super Solution's (RSS) business unit and fund consolidation (mergers) is now becoming a positive rather than a headwind.

We expect this trend of larger funds acquiring smaller funds that lack scale to play out further, which bodes well for LNK given its concentrated client base. For example, on 29th of June, LNK's RSS client Hostplus (with ~1.3m members) announced that it entered merger talks with Statewide SA (~140,000 members), which if consummated, we expect would benefit total member numbers by ~2% and lift earnings by a similar amount - another incremental positive.

Backing out the value of PEXA, the core business appears to be trading on 14 x FY22 consensus NPATA, a massive 44% discount to the All Industrial ex Banks PE of 25.2 x FY22. We think buying bombed out LNK shares at ~$5.00 is a much lower risk and cheaper entry strategy than buying PEXA in the pending IPO on 26.1 times pro forma EV/Ebitda. Over time PEXA, as a privileged asset will continue to trade akin to infrastructure securities, such as Transurban and Sydney Airport, commanding much higher multiples.

Downside risks to our view include:
- PEXA value crystallization disappoints.
- Loss of members in funds administration from recent Budget changes continues, but has largely played out.
- Link Asset Services fund solutions difficulties with the FCA Regulator in the UK.

Upside risks include:
- Higher value crystalisation for PEXA and the bigger prize could be in the UK, where the addressable market is $719m annually vs $280m in Australia.
- Accretive bolt on acquisitions.
- More contract wins in funds administration.
- Increasing member numbers in the industry funds segment, which is happening right now – heightened merger activity involving large accounts swallowing up smaller funds.
- Cyclical tailwinds from corporate actions.
- Higher-than-expected earnings growth from the Link Asset Services business.
- Repricing of Funds Admin contracts upwards to reflect the fixed-cost leverage issues from PYS legislation.

Suncorp Group (SUN)

SUN returned to the portfolio after the Fund fully exited the position at an average price of ~$14.80 back in July 2018. SUN is one of the largest general insurers in Australia and New Zealand, with a small but relevant Australian bank which accounts for one third of the group's total profit. SUN has experienced material share price weakness since the onset of COVID-19 on the back of uncertainty relating to Business Interruption (BI) wording in certain policies and has been slowly recovering from its 19 March 2020 lows. We see valuation appeal in SUN and feel the market is under-appreciating the inherent value in its banking business, at a time when insurance margins are depressed. Data is reflecting strong industry feedback for premium rises across most products.

SUN recently delivered a very solid 1H21 result against a very tough backdrop, with cash earnings of $509m, 11% above the company's guidance and up 39% on the prior comparative period. It was a meaningful beat to consensus expectations across all three key divisions - Insurance (Australia), Banking and Wealth and New Zealand. The 26cps 1H21 dividend was also above the 22cps consensus estimate. Other positives included, a 5-6% growth in GWP for the Australian Insurance segment in both home and motor insurance classes, and group operating expenses of $13bn were flat on the prior corresponding period. The bank delivered a solid result with NPAT up 11% on pcp, assisted by a strong net interest margin (NIM) performance (204bps, +12bps on pcp) and reduced impairments on an improving economic outlook (3bps as a % of GLA). At its update in May, impairment losses stood at just 1 bpt.

SUN's recent investor briefings, on both the general insurance business and the bank, point to a clear strategic plan to drive overall business improvement, however the market was underwhelmed by the benefits being back-ended and cautious with regard to execution risk. During the General Insurance (GI) presentation, the Group unveiled FY23E strategic goals, including targeting General Insurance underlying margin expansion from 7.1% in 1H21 to 10-12% by FY23E (with market expectations closer to ~9.5%). SUN's GI strategy, centered around better leveraging data and technology to drive operational efficiencies and optimize price, thereby enabling it to revitalize growth, which appears well suited to a post-COVID world. Despite underlying margins remaining around 1H21 lows of 7.1% in 2H21E (given higher expected project and operating costs), SUN expects a ~400bps uplift by FY23E, driven by:

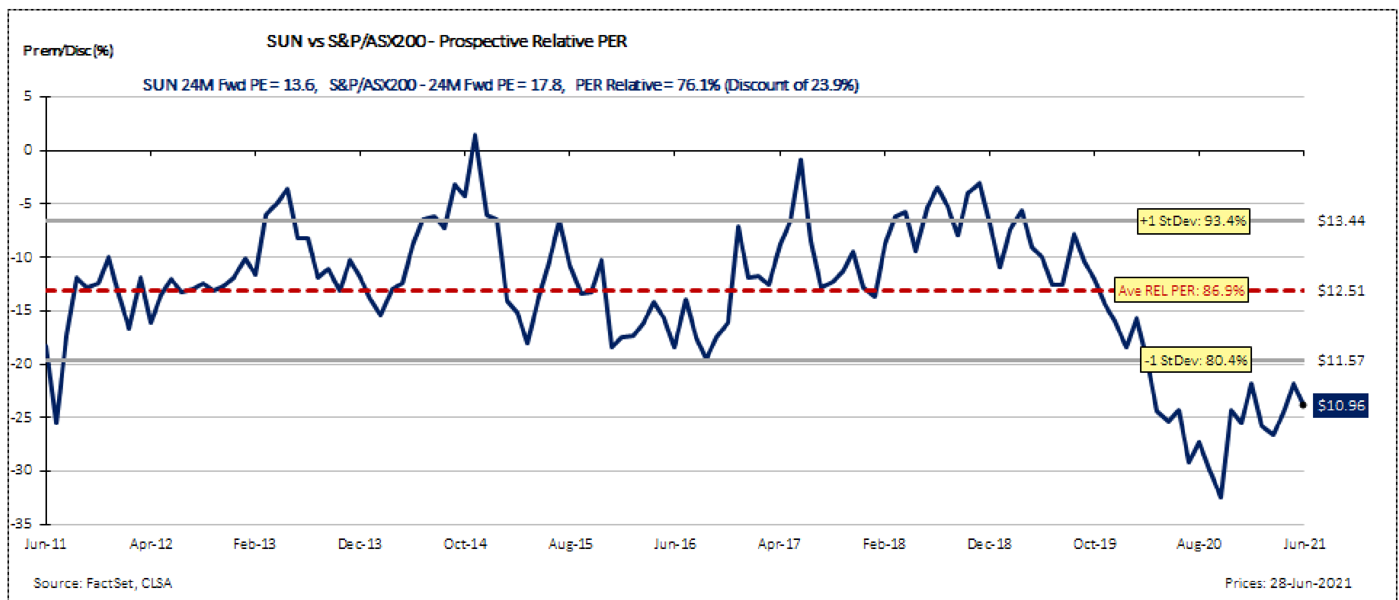
- 100bps repricing, largely in Home;
- 150-200bps loss ratio benefit from supply chain/operational improvements and pricing/risk selection enhancements; and
- 100-150bps expense ratio gain.

Encouragingly, digital interactions have continued to increase (1H21 home/motor digital sales +10%), and SUN noted favorable experience to-date in the long trail portfolios, suggesting it is on track for reserve releases of 1.5% in 2H21.

Also pleasingly, the Group confirmed the momentum in its banking franchise broadly continues as expected into the third quarter e.g. NIM remains strong (supported by lower funding costs), 3Q21 impairments losses of 1bps and a return to lending growth in February, March and April. We believe the value of the bank (book value currently stands at ~$4bn) and it's positioning in Queensland, is under-appreciated by investors. SUN's excess capital level (+$1bn) is also robust and potentially allows for special dividends down the track.

We have been observing the insurance sectors' relative underperformance (IAG was hit exceptionally hard on BI claims of $865m post tax and has also suffered from potential Greensill losses yet to be recognized). Apart from lingering BI concerns, where SUN management continue to maintain that it has adequately provisioned $195m for these policies, recent weakness can attributed to the severe weather affecting regions across metropolitan and regional Victoria midway through the month, causing extensive property damage that resulted in SUN lifting its total natural hazard to $955m, or $40m above its year to date allowance of $915m. The Group has a comprehensive reinsurance program in place, so the maximum loss from this event was contained at $50m.

Looking through the valley and taking a more medium term view, the broader trends are pointing to an improving earnings trajectory as we move into FY22.



29Metals (29M)

During the month, we participated in the IPO of 29Metals (29M) given its attractive valuation of 4.8x EV/EBITDA, a discount of 20%+ to peers, a 10+ year mine life and its major flagship asset, Golden Grove which is ~75% of the valuation, which sits is in the bottom quartile of the cost curve. We are positive on the long term outlook for copper, given the increasing demand from the energy transition - copper cuts at the heart of electrification, together with supply constraints will support higher long term prices. With 29M we were able to get the copper exposure at a very reasonable price.

29M is an Australian based polymetallic producer focused on copper, but with significant zinc and gold credits operating in locations considered Tier 1 jurisdictions according to AME (hence, low sovereign risk). The company is looking to increase copper equivalent production by ~40% over the next 3 years by executing defined growth plans across its two established underground operations at Golden Grove in WA and Capricorn Copper in QLD. Its reserves provide for a 10 year plus mine life and nearfield exploration offers potential for mine life extensions. Nearly $400m of capital has been spent over the past four years on development works to extend the mine life by EMR Capital, who will be retaining a 45% shareholding post IPO.

The rich by-product credits at Golden Grove offset costs and should ensure a cost position in the bottom quartile of global copper production e.g. at current commodity prices, the cash cost at Golden Grove is close to zero. Capricorn Copper's costs are in the top quartile, however, with increased throughput and grades over the next few years, it should achieve a 25% margin on a long term copper price of US$3.50/lb (note the current spot price is US$4.24/lb).

29M has an experienced management team which acquired unloved assets that were starved of investment and provided the necessary turnaround capital investment ($400m+). The team has grown the resource inventory and mine life, added processing mill enhancements and provided for higher output growth in the ten year mine plan.

29M listed on the 2nd of July and we would initially expect fairly muted short term performance, given the recent pull back in base metal prices (copper prices declined to 7-week lows but are still 55% higher than a year ago) and in the broader Resources sector. Freeport-McMoran has pulled back ~18% from its May highs as a reference point. That said, we are very confident on the medium term prospects for 29M for the reasons articulated above and bear in mind that current spot copper prices are above prospectus forecasts.

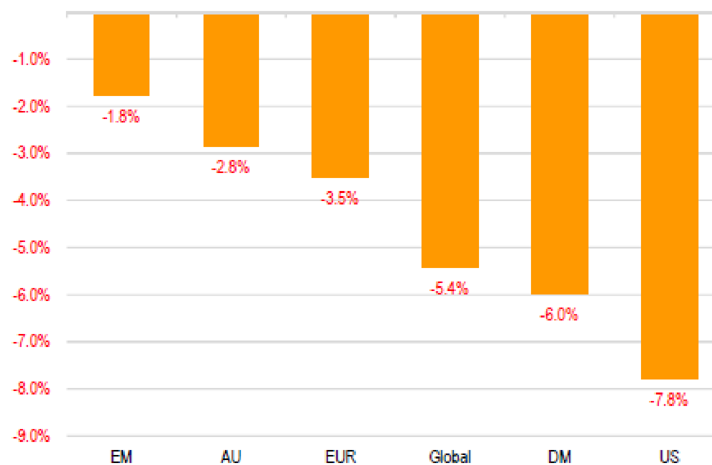
FUND STRATEGY AND OUTLOOK

There is little that has changed with respect to the Fund's strategy since our May update, although just to reinforce again, **we have recently culled our exposure to the banks and tempered some of our more economically cyclical domestic names which have done very well, in favour of a select number of quality defensives with competitive advantages, which have underperformed. We remain cautiously optimistic looking out into FY22.**

The Federal Reserve did what the market expected them to do a few months ago by acknowledging that the economy is red hot and that the Fed will have to start normalizing monetary policy sooner rather than later - a much more hawkish outcome than the market had anticipated. After dismissing rising inflation (as transitory) and focusing predominantly on the labour market, it feels like Powell has put his hands back on the steering wheel. Most importantly, the Chairman indicated that the Fed is done "talking about talking about tapering", alluding to taper discussions which may gather momentum at its next July meeting. Dallas Fed President Robert Kaplan, who's pencilled in a rate hike as early as next year, said the US economy will likely meet the Fed's threshold for tapering asset purchases sooner than observers think. His Atlanta counterpart, Raphael Bostic reinforced this by commenting that the central bank could decide to slow such purchases in the next few months.

The Fed has now officially flagged two rate hikes in 2023, despite only minor forecast economic revisions. Language changes (more hawkish) in the wording suggest the Fed is in fact finally responding to actual inflation data confirming that it is no longer undershooting its 2% target. Seven Fed members are now expecting a rate hike next year, despite non-farm payrolls missing "whisper" expectations sitting at 900,000 and came in at 559,000.

The Fed's U-turn in mid-June saw a stall in the Value rally and lower bond yields saw Growth take off in June

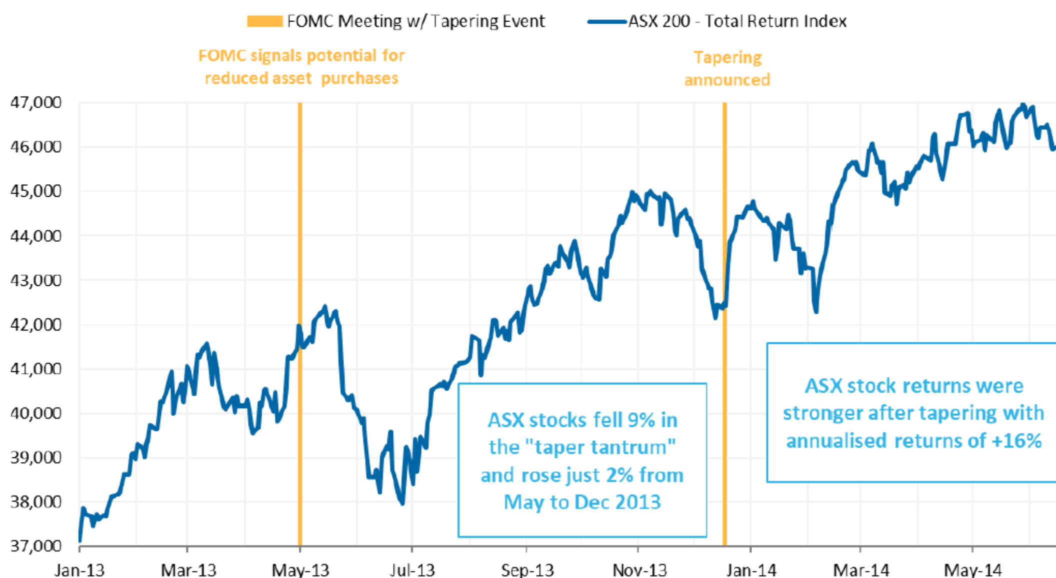


Source: JP Morgan.

The last "taper tantrum" in 2013, a sustained rise in real yields did not occur until after the Fed signalled the potential for reduced asset purchases in the May 1, 2013 FOMC statement. The real US 10-year yield was ~120bps higher 7 months later when tapering started. Real yields then fell modestly after tapering started, likely due to growth concerns. A month after tapering was first signalled, a global equity sell-off occurred that saw ASX stocks fall 9% in a month. All sectors fell in the taper tantrum, but Health, Media and Commercial Services fell the least. Mining was the worst, but this was after a commodity super cycle ended.

We believe potentially rising yields would be a larger valuation headwind today than in 2013 given PEs are 30% higher, but the key offset is that we have been in the strongest earnings upcycle in decades, and certainly stronger than 2013.

ASX stocks fell more in the taper tantrum than US stocks, but rose more in the following year

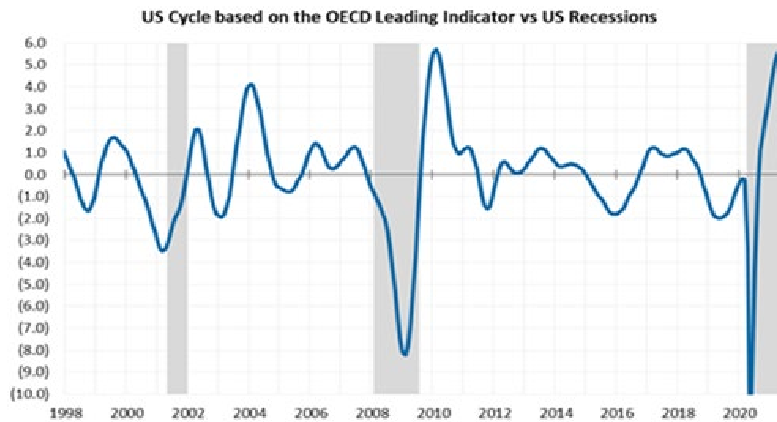


Source: Macquarie Research.

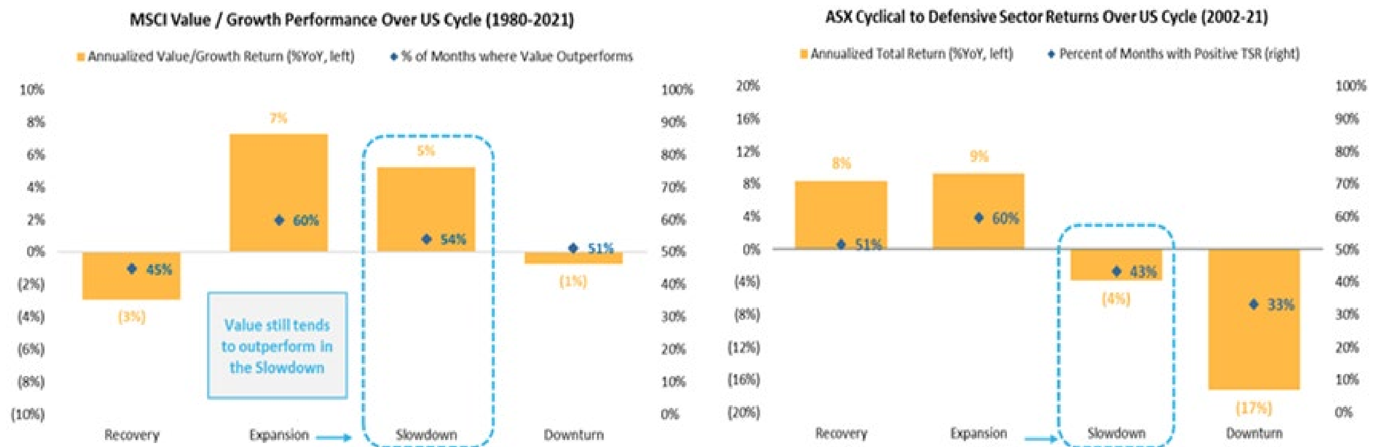
We may have reached a peak in stimulus following ~ US$30 trillion spent by Central Banks and Governments globally to fight the economic impact of COVID-19. Interest rate cuts by the developed economies are now firmly behind us. Rising bond yields off their lows due to higher input costs (commodities, labour, freight, etc.) should drive peak earnings growth for the ASX 200 in 2021, with momentum slowing in 2022.

US Manufacturing PMI may have already peaked. OECD leading indicators likely to shift to slowdown phase over the next few months. In recent cycles, the first slowdown phase has been followed by a second or third expansion phase i.e. the slowdown may not necessarily be followed immediately by a downturn.

Just to reiterate what we been saying recently, the strongest returns for risk assets have historically been in the recovery and expansion phase (this has already happened). **As we shift from an expansion to a slowdown in the rate of growth phase, the risk appetite typically falls with stock leadership in the market shifting to more quality defensive names (Healthcare and Staples)** as earnings growth rates for the market moderate. Value tends to still outperform during this slowdown period, but outperformance should become more balanced versus other Factors (Growth, Momentum, etc.). **Returns will be more stock related, rather than factor based, which suits active stock pickers like ourselves, so we are very excited by this backdrop.**



Source: Macquarie Research.

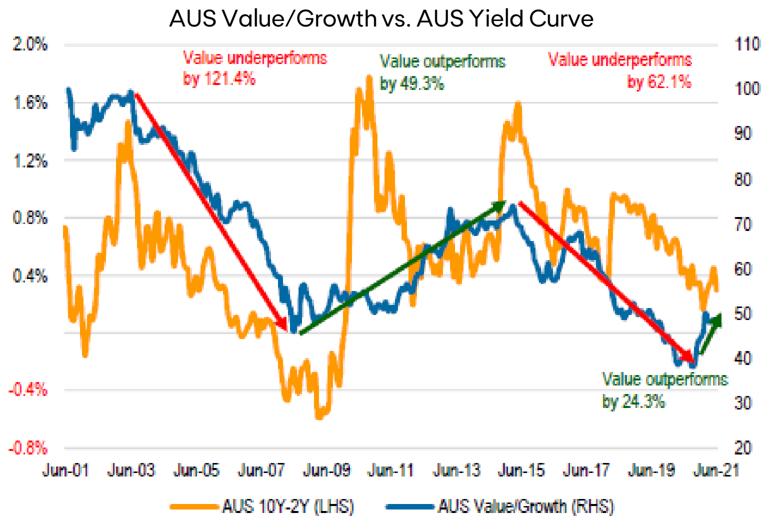


Source: Macquarie Research.

In our view, the case for selective Value names and sensibly priced quality industrial stocks remains intact. The upshot of the fear of a further rise in bond yields from inflationary pressures and the corollary of higher discount rates, continues to pressure the allocation away from growth scarcity trades and long-duration positioning, **but bonds have confounded everyone and in fact rallied!**

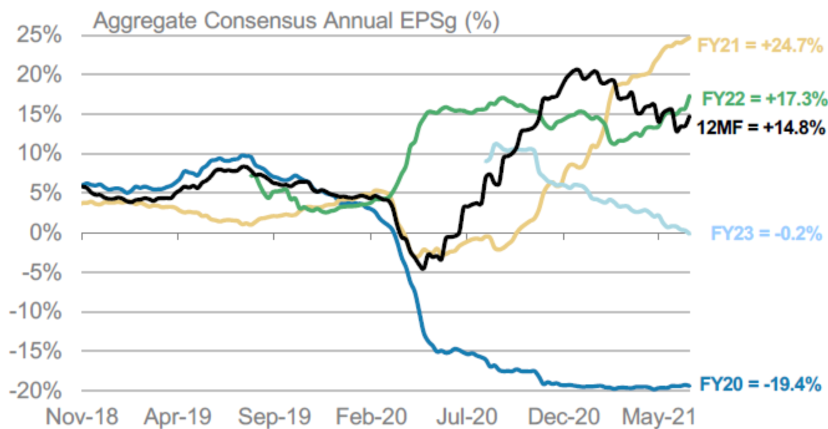
The deep value opportunity has largely passed (with many cyclicals more than doubling from their March/April lows of 2020), yet broader reflation exposure still makes sense, given global core inflation rates reached a quarter-century high in 1H21 and is expected to remain elevated throughout the rest of 2021.

AUS Value/Growth vs. AUS Yield Curve



Source: Morgan Stanley.

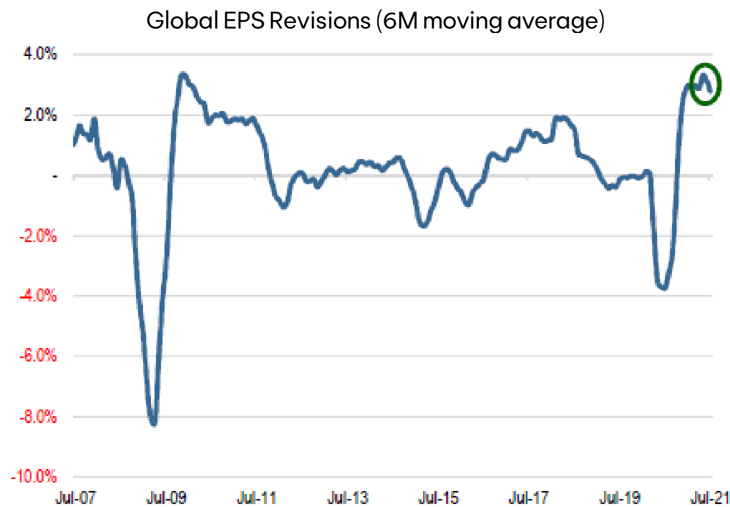
In Australia, Aggregate Annual Consensus EPS growth (%) Trends FY21-22: upward revisions



Source: Morgan Stanley Research.

Global earnings growth projections hit a record high in June of 54% yoy, with the 6 month rolling moving average reaching its strongest all-time level in May.

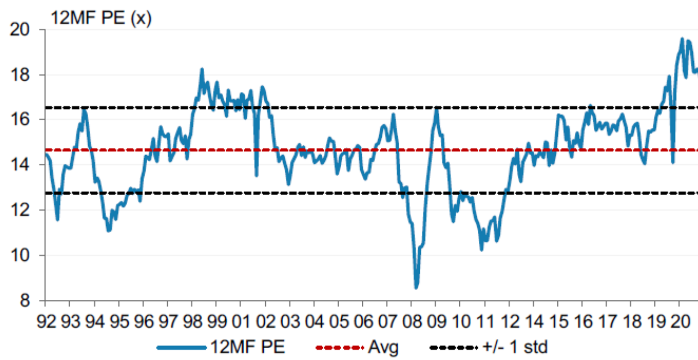
Global EPS Revisions (6M moving average)



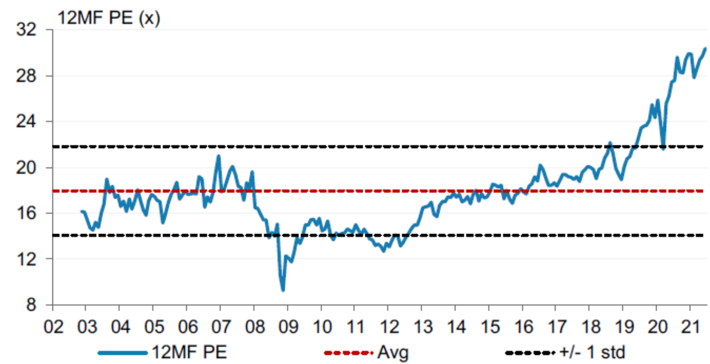
Source: JP Morgan.

With the US Q2 Earnings season kicking off on 13th July, FactSet is estimating earnings growth rate for the S&P 500 of 63.6%, marking the highest year-over-year eps growth rate reported by the index since Q4 2009 (108.9%). In terms of Valuation, the forward 12-month P/E ratio for the S&P 500 is now 21.4, which is above the 5-year average of 18.1x and also above the 10-year average (which sits at 16.1x). Given historically low interest rates, PE expansion is no surprise.

ASX 200 PE – 17.6x



ASX 200 Industrials ex Financials PE – 30.4x



Source: Morgan Stanley Research.

We remain positively disposed to markets but recognise, as ever, the challenge of stretched valuations in certain pockets of the market against the backdrop of potentially gradually rising interest rates. To reiterate, we continue to be invested in stocks that we believe are trading below our assessment of intrinsic value and where the market is underestimating their future medium term earnings and recovery prospects.

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

Aristocrat Leisure, Carsales.com, CSL, JB Hi-Fi, Link Administration (cheaper entry into Pexa), NextDC, Resmed and United Malt

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

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

Ampol, Graincorp and Suncorp Group

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

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)

29Metals, Deterra Royalties, Northern Star Resources, Paladin Energy and Western Areas

To conclude, we continue to hold two of the big banks, one regional bank in Bank of Queensland and Janus Henderson which trades on a PER of 10 times, a dividend yield of 4.0% and has net cash on the balance sheet.

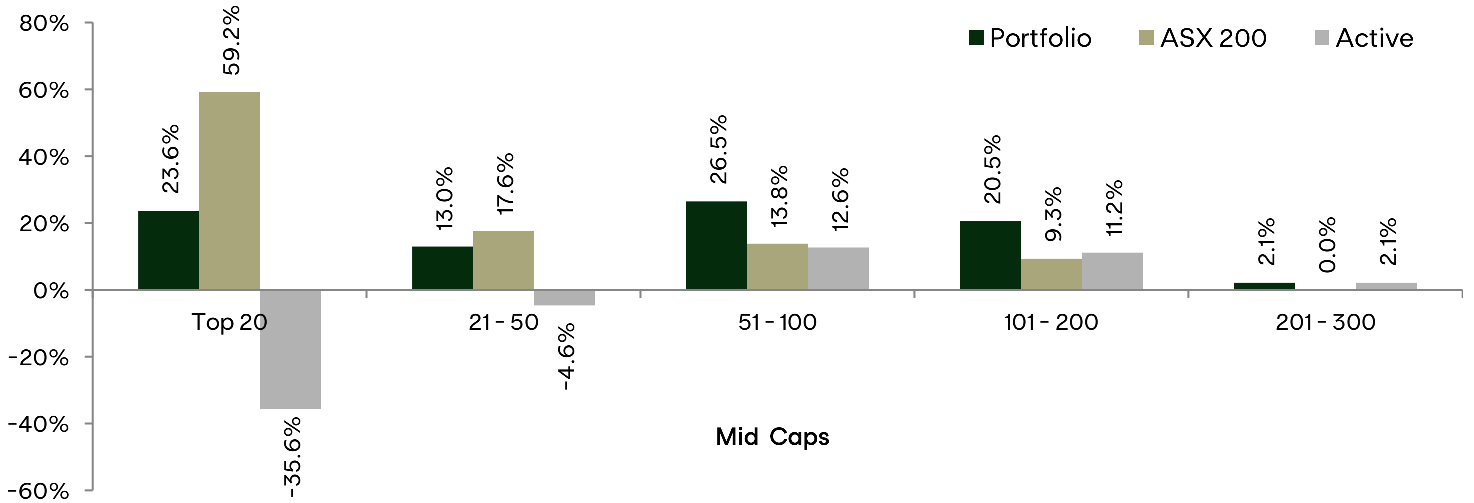
We are truly grateful for your continued support.

Warm Regards,

Chris Kourtis
Portfolio Manager

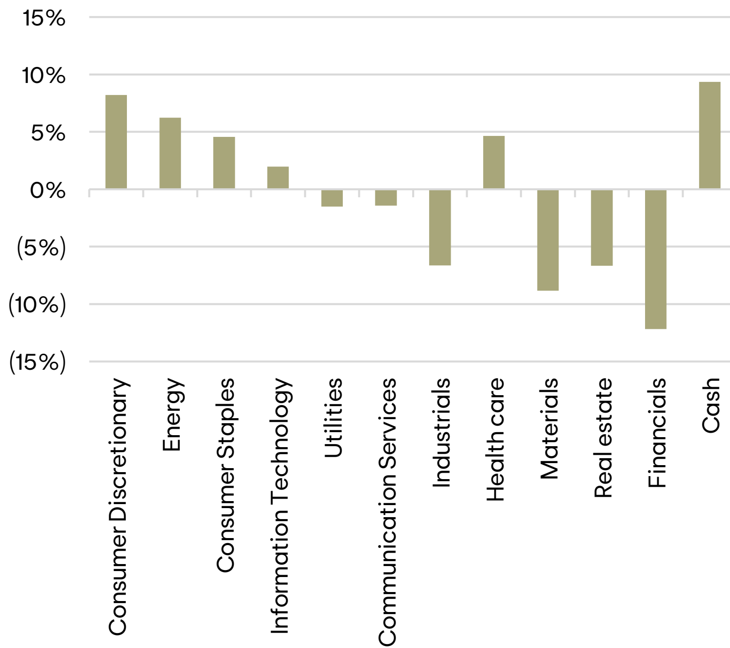
PORTFOLIO FEATURES

Size comparison Chart vs ASX 200^



^Size Comparison Data as at 30 June 2021
Source: Bloomberg, Ellerston Capital.

Active Sector Exposures*



TOP 10 HOLDINGS**
AMPOL
ARISTOCRAT LEISURE
CSL
DETERRA ROYALTIES
GRAINCORP
JANUS HENDERSON
JB HI-FI
NORTHERN STAR
RESMED
WESTPAC

Source: Ellerston Capital.

* 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	$800 Million
FUNDS UNDER MANAGEMENT – ASF UNIT TRUST	$3.61 Million
APPLICATION PRICE	$1.1180
REDEMPTION PRICE	$1.1124
NUMBER OF STOCKS	22
INCEPTION DATE	1 APRIL 2009

Source: Ellerston Capital.

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Find out more

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**

All holding enquiries should be directed to our register, Link Market Services on **1800 992 149** or **ellerston@linkmarketservices.com.au**

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