Ellerston Low-Vol Income Strategy Fund

Monthly Newsletter, August 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	$1.2088
Net Asset Value	$1.2058
Redemption Price	$1.2028
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^	3.40%	5.54%	17.54%	27.65%	13.41%	14.24%
Benchmark*	2.50%	5.97%	14.96%	28.15%	10.29%	11.52%
Alpha	0.89%	-0.43%	2.58%	-0.50%	3.11%	2.72%

^ 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

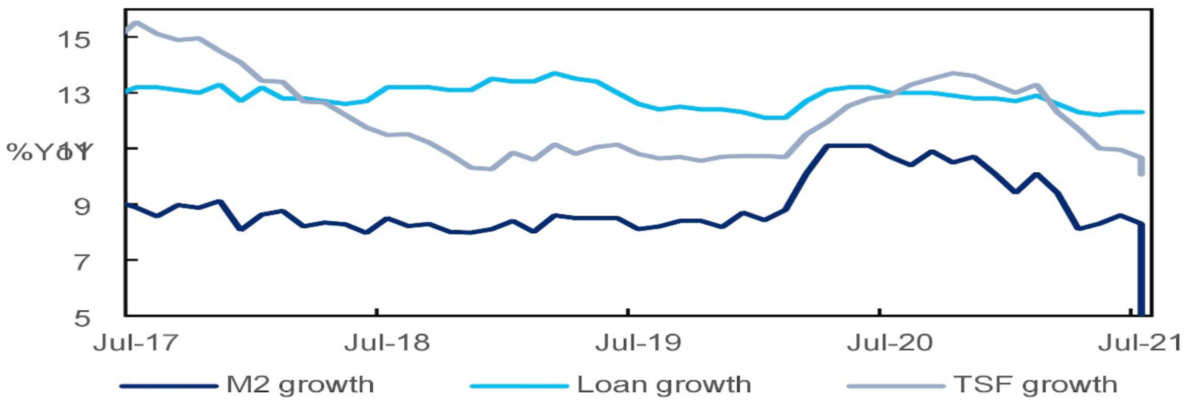
August delivered another positive month for global markets, with the S&P500 and ASX 200 rising 3.0% and 2.5% respectively, in local currency terms. This was driven by a) dissipating concerns that Central Banks' globally will be too aggressive with their well flagged tapering measures and timetable, b) slowing but manageable economic growth, and therefore earnings outcomes for equity markets and c) that the inflationary pressures currently being witnessed will be more transitory in nature, thereby providing a better behaved bond yield market that will further support equity valuations despite being elevated.

Global bond yields retraced in August, with the US 10 year government bond yield falling 21 bps to 1.23%. Federal Reserve Chair, Jerome Powell, continues to provide more dovish commentary on the economic outlook and push for stimulus withdrawal to be gradual and measured. The Australian 10 year bond yield stayed relatively flat over the month, declining 2 bps to 1.16% on lockdown uncertainty.

On the commodities front, Brent oil prices dropped US$3/bbl to US$73/bbl on global concerns around the Delta variant. Similarly, gold prices dropped slightly by US$10.90/oz to US$1,814/oz as real interest rates continued their recent decline. The copper price declined by 2.8% over the month over concerns that global industrial production may be entering a softer patch.

China saw its equity market broadly stable in August with the CSI 300 Index mostly flat, following an 11% decline in July. Monetary policy normalisation coupled with a sluggish implementation of budget fiscal policy has caused renewed focus on their economic slowdown. These economic issues, along with the regulatory clampdown on internet platform companies and the after-school tutoring sector has also dented confidence in the market. Economic growth is likely to slow to around 5.5% in 2022, which places pressure on Australia, as we are highly China dependent for trade, especially in commodities. We have already seen a meaningful pullback in the iron ore price, falling $34/Mt over August, or 18%, to US$156/Mt as Chinese steel demand continues to weaken from a softening economy. This price weakness has continued into September. The softening economy is captured in the data below.

China money supply / loan / total social financing / growth



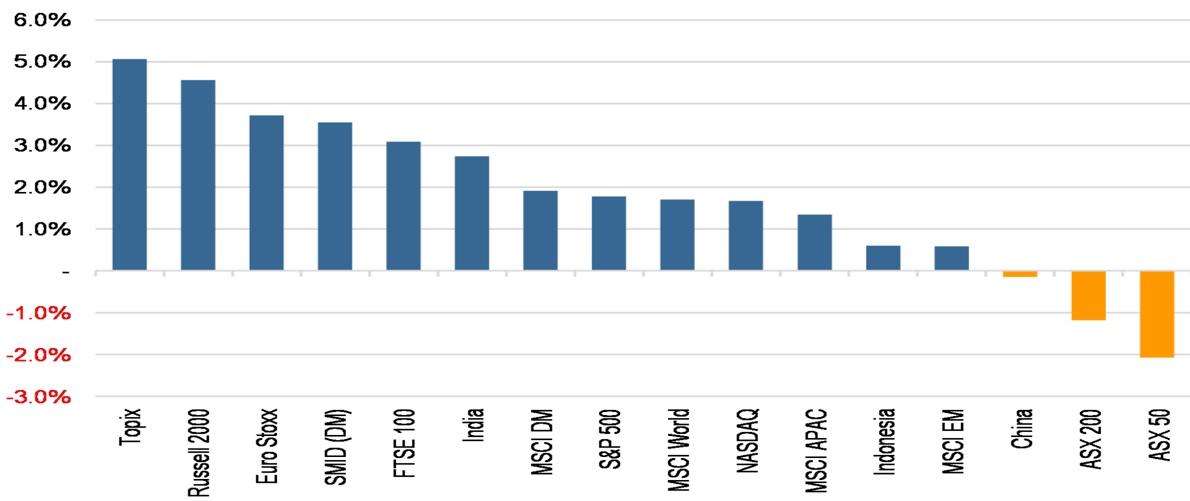
Source: Citibank.

Iron Ore Chart

Source: Trading Economics.

In Australia, we witnessed a very robust reporting season, with the beats vs misses ratio of results compared to market expectations being the second highest on record. According to UBS Securities, around 40% of large cap companies beat on earnings, 28% beat on dividends and 18% provided positive earnings guidance going forward. Earnings guidance provision was lower than normal given the difficulties determining the timing and impact of current lockdowns across the major states of New South Wales and Victoria. However, when considered in a global context, earnings revisions in Australia have been by far the weakest through August, with both the ASX 200 and ASX 50 at the bottom of the table.

Global EPS Revisions in August

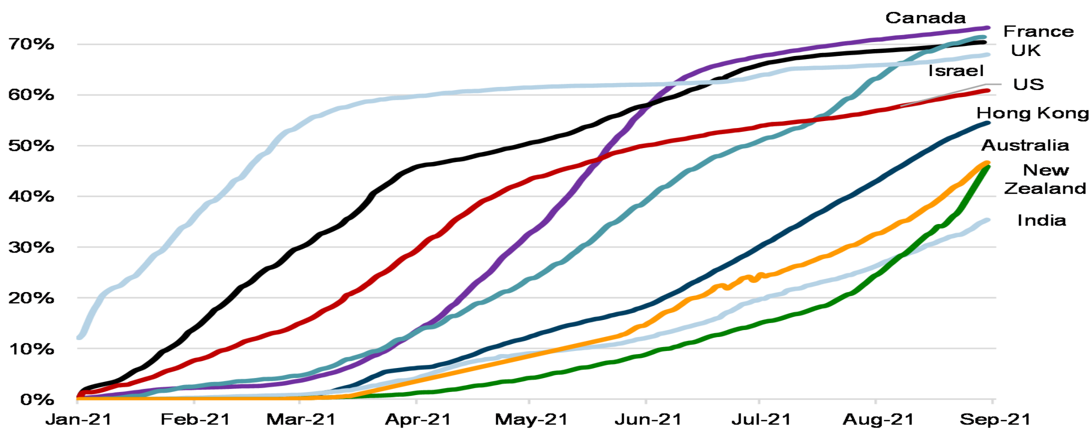


Source: JP Morgan.

Of some concern is the renewed surge in global COVID cases from the delta variant. Global COVID cases passed 216m cases in August, a material 10.2% increase on the July case numbers. According to the OWID, the US currently leads global daily cases with 160,000, on a 7 day rolling average basis, followed by India at 42,000 and the UK at 33,000. The US also leads in terms of total cases, 39m, followed by India, 33m and Brazil, 21m people.

Globally, we have now seen more than 5.0 billion COVID vaccines administered, with around 40% of the world's population having received at least one dose of vaccine. Countries with the largest share of population fully vaccinated include the United Arab Emirates (72%) and China (62%). Australia continues to lag behind global counterparts with its vaccine rollout with only 30% fully vaccinated, but dosage rates are beginning to escalate meaningfully.

Global Vaccination Rates



Source: JP Morgan.

In Australia, NSW remains in hard lockdown but the Premier is seeking to ease restrictions in October for fully vaccinated people. On 30th August, NSW reported 1,290 new COVID cases as the delta variant continues to see daily cases rise. The state had administered 6.8m vaccinations at the end of August, with 2/3rds of the population having received one vaccine dose and 36% now being fully vaccinated. The Premier has stated that NSW is on track to having 70% of people fully vaccinated in October, giving the green light for the Premier to ease lockdown restrictions and allow NSW businesses to resume trading. However, easing lockdown restrictions will only apply to fully vaccinated people.

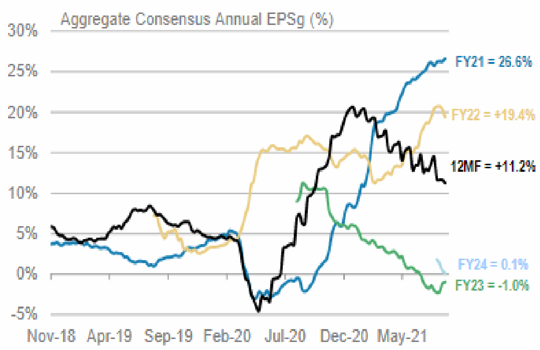
Victoria continues to extend its hard lockdown timeline as COVID daily cases continue to rise but the Andrews Government is now accepting that a zero COVID case world is extremely unlikely going forward and now looks set to embrace a slow removal of lockdown restrictions as vaccination levels rise.

Australian company earnings and market valuations

After a strong upgrade cycle for much of this calendar year, earnings momentum has potentially stalled, with growth rates rolling over and aggregate EPS levels looking to have peaked for now. Supply chain and freight costs have been consistently called out in Industrial outlooks, and for domestic-facing companies, the ever extending lockdowns in the key states of NSW and Vic (attached to higher alert levels from other states) are at the very least resetting earnings bases lower for FY22e and asking more of the second half.

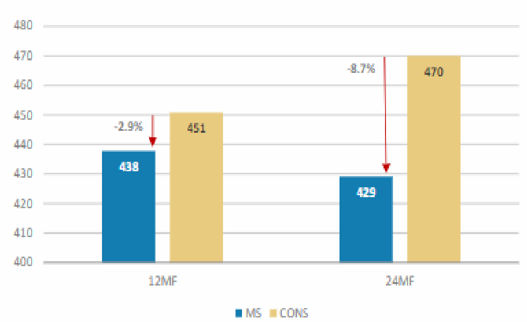
According to Morgan Stanley, what we have seen is that there is a clear rollover in growth rates with FY22e earnings per share growth now 19.4% and FY23e growth at negative 1% when using bottom-up consensus. This data is typically lagged and should retrace further as full data from the season is captured and commodity assumptions re-based at the next quarter. When using Morgan Stanley data, this implies analyst forecasts will see around 3.0 % downside to aggregate estimates in FY22e.

Exhibit 5: FY22e EPSg Looks to have Rolled Over



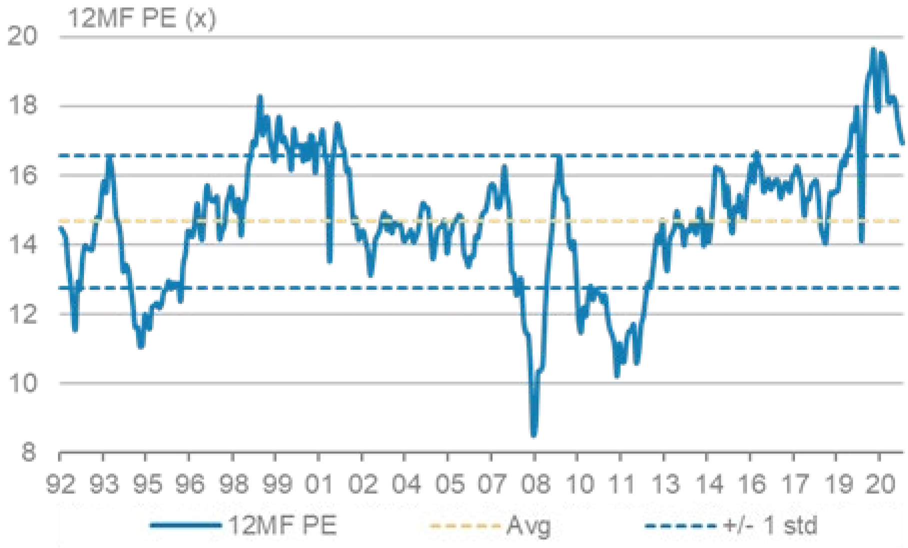
Source: IBES, RIMES, Morgan Stanley Research

Exhibit 6: MS aggregate implied EPS is tracking 2.9% below consensus on a like for like basis*



Source: Factset, IBES, Modelware, Morgan Stanley Research. Data as at August 31, 2021. *consensus estimates limited to MS stock coverage within the ASX 200 universe.

Valuations continue to look elevated, but not alarming, in an environment where earnings growth forecasts are beginning to slow. The Australian market is now close to one standard deviation from its long term average post earnings upgrades over the past few months.



Source: Morgan Stanley.

Fund Performance

We continue to see a decent unwind of the cyclical value trade as recent economic data out of the U.S and China points to a slowing of global GDP growth. This has been further supported by a stabilisation in bond yields following a decent pullback. The global surge in the delta strain of COVID-19 has forced many cities into lockdown again, thereby placing the robust economic recovery at risk of a slowdown. A consequence of this is likely to be a gradual and measured withdrawal of Central Bank stimulus, thereby keeping bond yields more subdued for a longer timeframe. This is likely to support equity valuations a little longer than previously expected as liquidity provision from Government's and Central Banks continues unabated.

For the month of August, the Fund outperformed its benchmark by 0.89% on a relative, net basis, achieving a monthly absolute return of 3.40%.

From a sector and stock perspective, relative out performance came from Consumer Discretionary (owning Domino's Pizza) and Financials (Steadfast, ASX Limited & National Bank). Not owning BHP Limited and Fortescue Metals also helped portfolio performance for the month. The biggest detractor to performance was being overweight Mineral Resources and not owning Afterpay.

Given the meaningful premium the Australian market is trading on relative to its history, the medium term impact of rising interest rates on valuation multiples could be quite pronounced should rates renew their upward trajectory. However, this outcome may be now be delayed by several months until vaccination rates reach higher levels and our economy opens up again.

Portfolio Activity – Major Transactions

During the month we exited our position in Rio Tinto ex dividend and Mineral Resources following a very strong period of performance. We took the decision to lower our exposure to iron ore earlier in the month as China continues to deliberately slow its steel output on environmental grounds, thereby further pressuring the iron ore price. We expect the iron ore price will find a lower, more sustainable level going forward, thereby mitigating the superior performance we have seen from these companies for a period of time. We also exited our position in Ansell following a softer than expected result and believe that the COVID tailwinds which have benefited the stock's company earnings are now subsiding.

These stocks were replaced by the initiation of new positions in Star Entertainment Group, Cleanaway Waste Management and Australian Finance Group.

Star Entertainment owns and operates casinos and hotels in Australia with a focus on gaming facilities, nightclubs, bars, restaurants and exhibitions. This company should strongly benefit from the re-opening theme in NSW at a time when its main competitor is facing meaningful idiosyncratic challenges. Its valuation is looking very compelling. Cleanaway Waste Management provides services to industrial, hospitality, mining, retail and government sectors. Its relative valuation looks compelling compared to its trading history and will benefit from the economic recovery as the re-opening gathers momentum. Australian Finance Group is one of Australia's largest mortgage brokers and continues to benefit from market share gains at the expense of the major banks. We see this market share trajectory as structural and its valuation looks compelling.

Macro News

In August, US economic activity indicators were mixed, with the manufacturing ISM coming in below expectations at 59.5. Non-farm payrolls rose 943,000, well above expectations, but the unemployment rate ticked up to 5.4% due to flat participation. July core CPI rose 0.3% for the month, seeing the annualised inflation rate hit 4.3%. July retail sales fell 1.1% month on month, below expectations, as were housing starts, falling 7.0%.

China economic data continues to look softer with the Caixin manufacturing PMI for July ticking down to 50.3, below expectations. Activity indicators in Europe were also mixed with the flash Eurozone manufacturing PMI for July coming in ahead of consensus but the composite PMI coming in a little weaker.

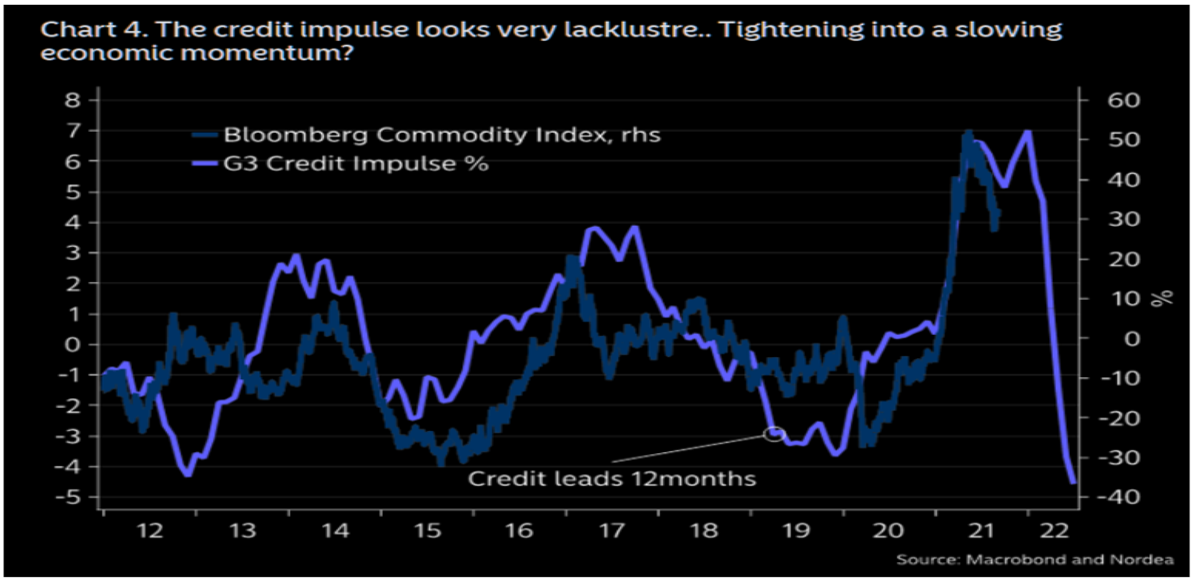
Australian economic data showed dwelling prices still booming in July, rising 1.9% for the month, the strongest since February 2004. Price rises were broad based across the country, with Sydney posting the strongest yearly increase at 18.2%. Capital expenditure numbers surged in Q2, rising 4.4% quarter on quarter and 11.5% on a rolling 12 month basis, the best since 2012. Equipment purchases, boosted by fiscal stimulus, and building activity were the standouts but mining capex only rose modestly and manufacturing retraced. Notably, the capex outlook survey completed in July & August shows resilience despite the commencement of lockdowns in Sydney and Melbourne. This is not expected to hold up if lockdowns are extended. July residential approvals worsened again for a 4th consecutive month, falling 8.6% month on month, with lockdowns affecting the pipeline of project commencements.

Finally, Gross company profits rose 7.1% in the Jun-21 quarter. This was driven primarily by the 18.4% quarter on quarter surge in mining profits. As expected, profits in accommodation & food services (-19.8% q/q) and retail (-5.7%q/q) contracted in 2Q21. Both sectors benefited from the Job Keeper wage subsidy program which rolled off at the end of 1Q. The removal of government support has, however, not impacted the labour market as evidenced by the 2.0% rise in wages and salaries.

Fund Positioning

The Fund continues 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. We have moderated our overweight position in Value stocks as a result of this and have increased exposure to defensive quality stocks.

We have particularly lightened our resources exposure on the back of an expected slowdown in global economic growth once we enter the tapering / deleveraging phase by Central Banks and the private sector. This will result in a major slowdown in the credit impulse, which leads the commodity index by 12 months, as shown below.



The beta of the Fund (a measure of volatility) sits at 0.88 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 21.7% and 13.4% respectively. The expected dividend yield of investee companies held within the portfolio is currently 3.0%, 79% franked vs the market dividend yield of 3.9 %, 81% franked.

Portfolio Characteristics

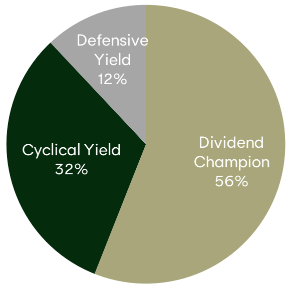
TOP 10 HOLDINGS

National Australia Bank Limited	8.0%
CSL Limited	7.6%
Westpac Banking Corp	7.6%
Woolworths Group Ltd	6.3%
Sonic Healthcare Limited	4.2%
Aristocrat Leisure	3.6%
Tabcorp	3.6%
Brambles	3.5%
Domino's Pizza	3.5%
Dexus	3.4%

KEY PORTFOLIO METRICS

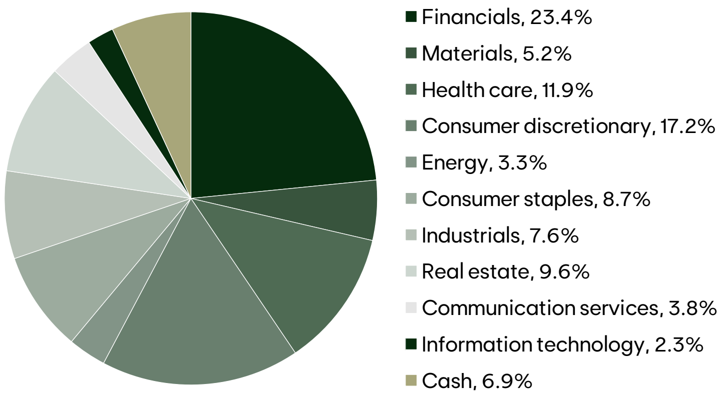
FY22(e)	Fund	Benchmark
Price/Earnings (x)	21.4	17.7
Dividend Yield (%)	3.0	3.9
Dividend Growth Rate (%)	21.7	13.4
Beta	0.91	1.00

PORTFOLIO YIELD EXPOSURE



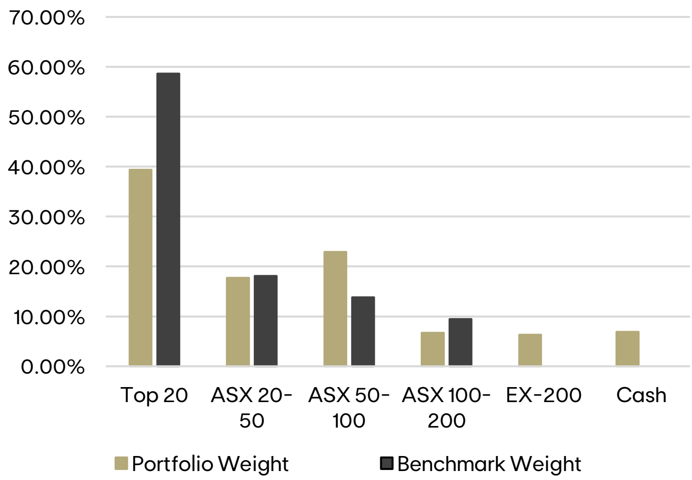
Source: Ellerston Capital.

SECTOR ALLOCATION



Source: Ellerston Capital.

MARKET CAPITALISATION



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Find out more

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Or visit us at ellerstoncapital.com

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