Ellerston Low-Vol Income Strategy Fund

Monthly Newsletter, September 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	$1.1814
Net Asset Value	$1.1785
Redemption Price	$1.1756
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

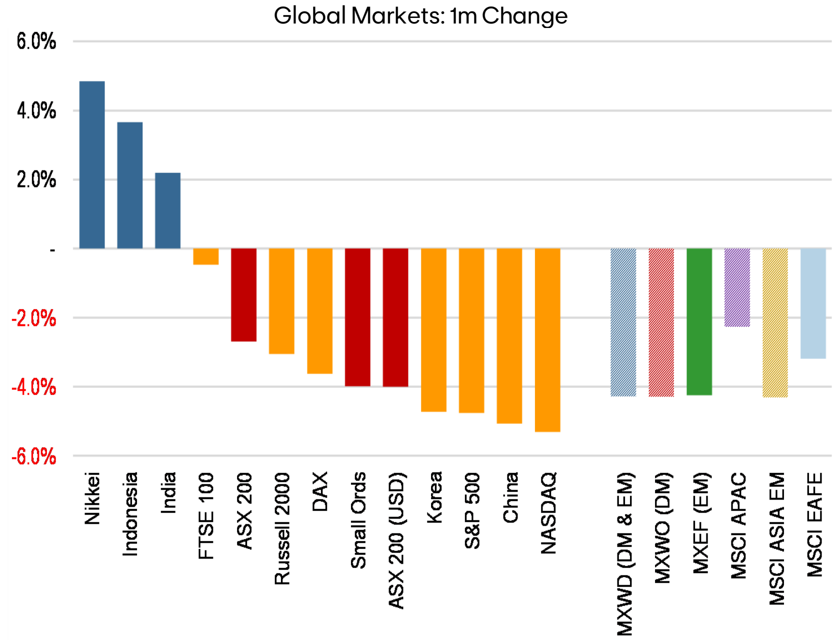
Performance	1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	Since Inception (p.a.)^^
Net^	-2.26%	1.17%	11.57%	27.84%	11.71%	12.64%
Benchmark*	-1.85%	1.71%	10.14%	30.56%	8.27%	10.24%
Alpha	-0.41%	-0.54%	1.42%	-2.72%	3.44%	2.40%

^ 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

September has historically been the weakest month for equity markets and it certainly didn't disappoint in 2021. The Developed Market World Index declined 3.6% in local currency terms, led predominantly by a 4.7% decline in the US market (S&P 500). The ASX 200 fared much better on a relative basis, declining 1.9% for the month.

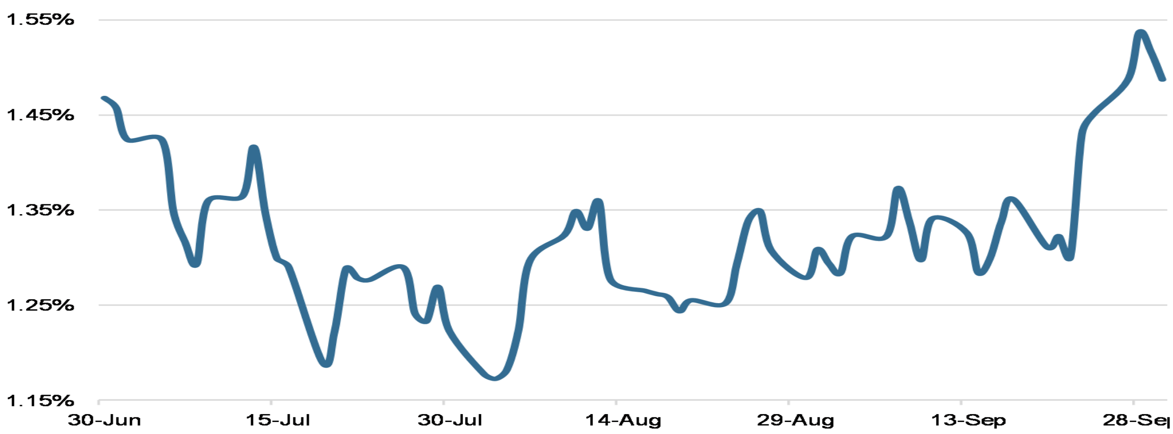


Source: JP Morgan.

The main drivers of global market weakness were as follows: (1) The evolving demise of Evergrande, China's largest property developer, causing a sell-off in Chinese developer bonds and uncertainty over the rising risk profile for the banking sector. (2) The US Federal Reserve shifting to a hawkish direction by signalling an earlier and faster pace of tapering of asset purchases (US Treasuries and Mortgage Backed Securities). (3) The regulatory slowdown of China steel output for decarbonisation reasons, leading to a collapse in the iron ore price and (4) continued global supply chain bottlenecks caused by COVID, thereby negatively impacting economic growth forecasts and lowering company earnings growth expectations.

All of the above contributed to global yields continuing to surge higher, with the US 10 Year Treasuries rising 24 bps to 1.52% and Australian 10 Year Treasuries climbing 33 bps to 1.49%.

US 10 Year Yield



Source: JP Morgan.

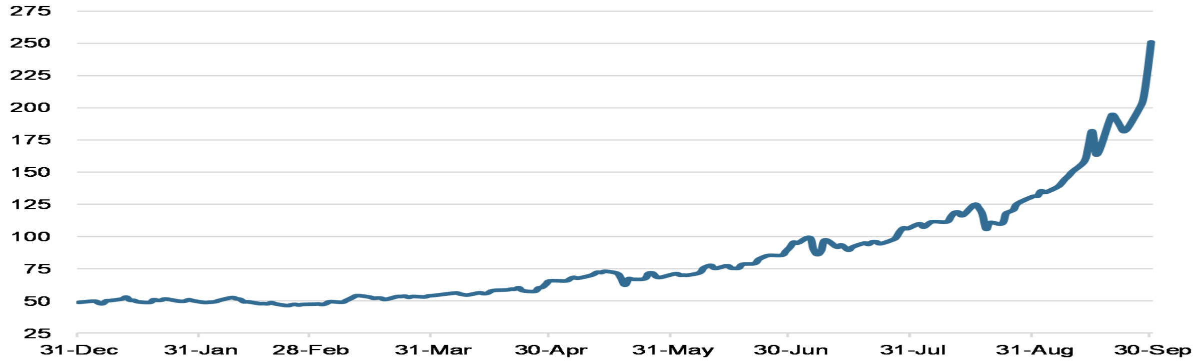
On the commodities front, Brent Oil also rose US$6 per barrel to US$79.00 per barrel, driving inflation expectations higher. Consequently, China announced an unexpected Strategic Petroleum Reserve Release along with OPEC planning to increase daily output by 400,000 bbls. The iron ore price collapse was brutal, falling from US$247/Mt to US$110/Mt on the back of slowing China crude steel demand. The Chinese Central Government continues to pressure provinces to materially cut energy consumption and intensity (post a large rise in 1H) to meet the 2021 target cut of 3% year on year. Interestingly, the gold price fell US$72/Oz to US$1,742/Oz on the back of rising real yields and a higher USD.

Additionally, China's coal shortage and subsequent power outages has led to domestic coking coal prices rising almost four fold from their trough in June 2020. Specifically, the strength in prices in China has been driven by: (a) Supply constraints as the Chinese government has started safety checks on coal mines and strictly prohibited overproduction in 1H21 after several coal mine accidents and (b) Imports of coking coal have disappointed due to the banning of deliveries from Australia and COVID border restrictions impacting imports from other countries. Finally, following decades of depressed prices, global gas prices are trading at an extraordinary 170% of oil prices due to tight gas inventories in Europe.

Iron Ore Price (62% Fe)

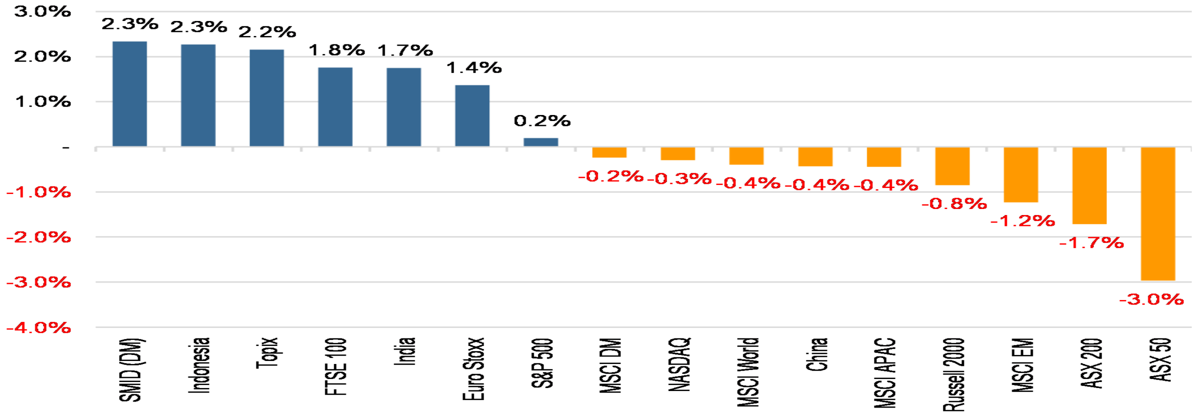
Gold Price

Source: Trading Economics.



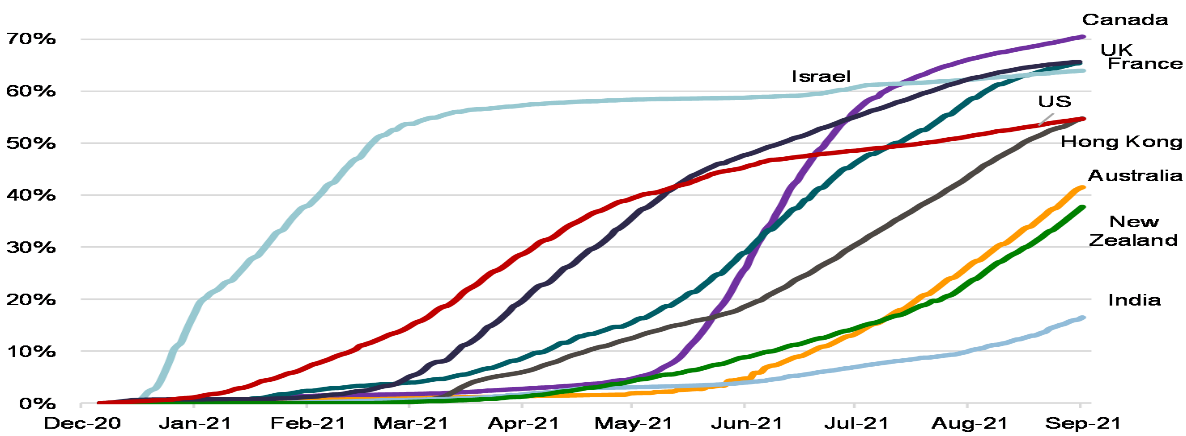
Source: JP Morgan.

In Australia, the weak market performance in September was also driven by inflation fears and a hawkish shift in interest rate direction by the Federal Reserve placing pressure on valuations. On the back of rising inflation, cyclical Energy (+16.7%), Utilities (+2.5%) and Financials (+1.6%) sectors all outperformed. The sectors which underperformed the most locally were Materials (-9.3%), Healthcare (-4.9%) and IT (-3.9%). Global EPS Revisions in September continued to slide, with Australia seeing the biggest downgrades.



Source: JP Morgan.

After a slow start, Australia's vaccination roll-out has accelerated sharply, with first doses administered now ahead of the US. As shown below, Australia is still some way behind on a fully vaccinated population basis, but we are closing the gap quickly given the vaccination drive being undertaken in NSW and VIC.



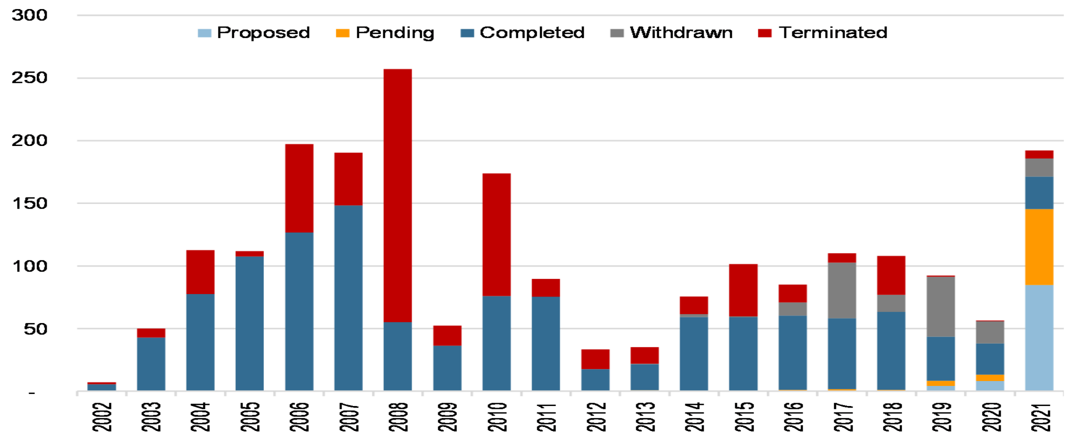
Source: JP Morgan.

A key factor of lifting vaccination rates has been the promise of re-opening once certain target levels of vaccination are reached. In NSW, the first stage of restriction easing commenced once vaccinated people hit 70%. This is fast approaching, with further restriction removals likely at 80% and 90%. NSW re-opening is critical for the national economy, with nearly 60% of the total population still in lockdown. Pleasingly, daily cases in NSW are now well below the mid-September peak but Victoria is still rising.

Australian M&A Cycle

A key feature of 2021 has been the strength of the Mergers & Acquisitions cycle with the ASX 200 value of M&A at its highest level since 2006. Around $200 bn of activity has occurred year to date with more deals likely before year end. This sort of activity is symptomatic of near end of cycle behaviour.

ASX 200 M&A Deal Value ($bn)



Source: JP Morgan.

Fund Performance & Commentary

The main driver of markets continues to be declining COVID cases, with the Delta wave appearing to have peaked in the US and globally. This should lead to a re-acceleration in economic activity into 2022. Despite this, an area of concern is the continued pace of downgrades to expected earnings and dividends in 2022. Australia continues to be one of the worst affected markets, primarily due to falling commodity prices (iron ore, copper), with September earnings and dividend revisions for 2022 of -3.0% & -3.4% respectively. Rising bond yields due to higher inflation expectations will favour cyclical/value stock outperformance in the near term. Once tapering begins it is expected that quality / defensive stocks will start outperforming throughout 2022 as economic growth begins to slow.

For the month of September, the Fund underperformed its benchmark by 0.41% on a relative, net basis, achieving a monthly absolute return of -2.26%.

From a sector and stock perspective, relative outperformance came from Materials (not owning BHP Limited, Rio Tinto and Fortescue Metals). The biggest detractor to performance was being underweight Financials (not owning Commonwealth Bank and Macquarie Group) and Energy (not owning Woodside Petroleum, Santos and Oilsearch).

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, which seems likely.

Portfolio Activity – Major Transactions

During the month we exited our position in Domino's Pizza Enterprises on valuation grounds after a stellar performance since purchase. We also exited our position in Sealink Travel Group over concerns the company would not win a $3.0bn Melbourne Metro Bus Contract despite being embedded in the share price. This proved to be the case, with the stock falling 17% since we sold our position post missing out on the contract. We also exited Sonic Healthcare, another stellar performer since we launched the fund, on valuation concerns and peak earnings given they have been a major beneficiary of COVID through highly elevated testing. Finally, we exited Brambles after they outlined elevated opex and capex in coming years at their strategy day, resulting in a disappointing downgrade to future earnings guidance.

These stocks were replaced by the initiation of new positions in Insurance Australia Group, QBE Insurance and Amcor, all beneficiaries of a steepening yield curve and inflation.

Insurance Australia Group Limited (IAG) is an Australian-based international general insurance group with operations in Australia, New Zealand, and Asia. The Group provides a range of personal and commercial insurance products, primarily motor vehicle and home insurance.

QBE Insurance Group Limited is an insurance company which underwrites most forms of commercial and industrial insurance policies, as well as individual policies. QBE also manages Lloyd's syndicates and provides investment management services. The Company provides its services both domestically and internationally.

Amcor PLC operates as a packaging company. The Company offers wide range of flexible and rigid packaging, specialty cartons, closures, and services for food, beverage, pharmaceutical, and medical sectors. Amcor serves customers worldwide.

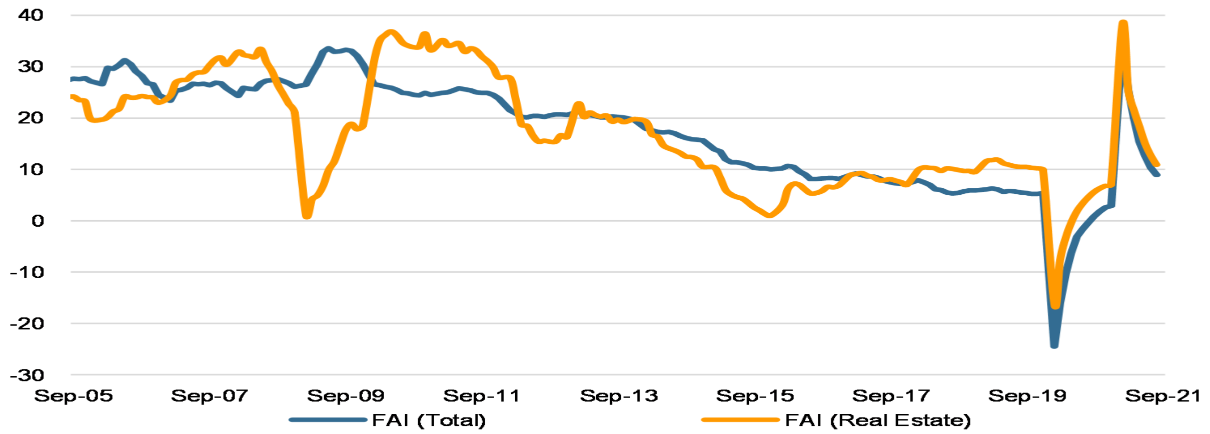
Finally, we added a new position in Centuria Industrial REIT via a A$300m placement at $3.80 per share. Capital raised will be used to purchase four, high quality urban infill industrial assets plus four other assets for consideration of A$351.3m. The company offers low earnings volatility with growth and an attractive dividend yield of 4.6%.

Macro News

In September, US economic activity indicators continued to be mixed, with the manufacturing ISM ticking up to 59.5, above expectations. Non-farm payrolls rose just 235,000, well below expectations, but the unemployment rate remained stable at 5.2% due to flat participation. August core CPI rose 0.1% for the month, seeing the annualised inflation rate hit 4.0%. AUGUST retail sales rose 0.7% month on month, above expectations, as were housing starts, rising 3.9%.

China economic data continues to look softer with the Caixin manufacturing PMI for August moving down to 50.0, below expectations, no longer showing any manufacturing output expansion. Consequently, this continues to justify further downgrades to economic growth forecasts. Consensus GDP growth for 2021 has been further lowered from 8.7% to 8.3%. The property market slowdown is a structural issue as well as a cyclical one and is expected to accelerate in 4Q.

China Real Estate FAI (YoY %)



Source: JP Morgan.

Activity indicators in Europe were also mixed with the flash Eurozone manufacturing PMI for August coming in ahead of consensus but the composite PMI coming in a little weaker.

In Australia, economic growth continues to recover strongly with 2Q real GDP rising by 0.7% quarter on quarter. The year on year rebound is now 1.6% above the pre COVID peak recorded in Q4'19, among the best of major economies (ex China). Also, despite lockdowns the Core Logic dwelling price growth in August only ticked down slightly to 1.8% growth month on month. This took the year on year dwelling price growth rate to 18.3%, the fastest since 1989. Residential building approvals also rebounded strongly in August, rising 6.8% for the month after four straight months of falls. The labour market continues to surprisingly remain resilient despite broad and severe lockdowns across the country. The unemployment rate has ticked down further to 4.5%, the lowest since just prior to the GFC struck in 2008. Finally, NAB business confidence rose 14.2 points in August, up from 10.1 points the month prior whilst the Westpac Consumer Sentiment Survey increased 2.0% due to vaccine rollout optimism and greater clarity on the roadmap to exit lockdowns.

Fund Positioning

The Fund is comfortable with its current exposures to the various yield segments (Cyclical, Defensive, Dividend Champions) and we note that, as per our previous commentary, bond yields are moving higher and are likely to continue to do so into year end. This will place further valuation pressure on the market, especially high multiple growth stocks. An imminent taper, or expectations of it, is expected to be the catalyst that drives real and nominal bond yields higher.

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 23.7% and 10.4% respectively. The expected dividend yield of investee companies held within the portfolio is currently 3.2%, 72% franked vs the market dividend yield of 3.8%, 80% franked.

Portfolio Characteristics

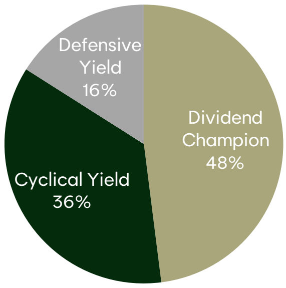
TOP 10 HOLDINGS

National Australia Bank Limited	8.2%
Westpac Banking Corp	7.8%
CSL Limited	7.4%
Woolworths Group Ltd	6.0%
Aristocrat Leisure	3.8%
Tabcorp	3.8%
Dexus	3.5%
Ampol	3.5%
Centuria	3.1%
OZ Minerals	3.1%

KEY PORTFOLIO METRICS

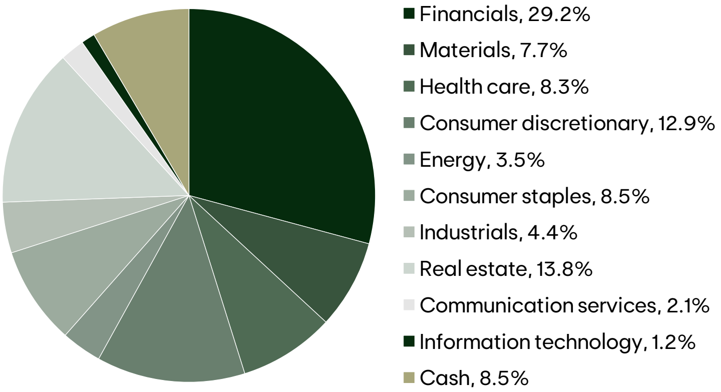
FY22(e)	Fund	Benchmark
Price/Earnings (x)	20.3	18.0
Dividend Yield (%)	3.2	3.8
Dividend Growth Rate (%)	23.7	10.0
Beta	0.90	1.00

PORTFOLIO YIELD EXPOSURE



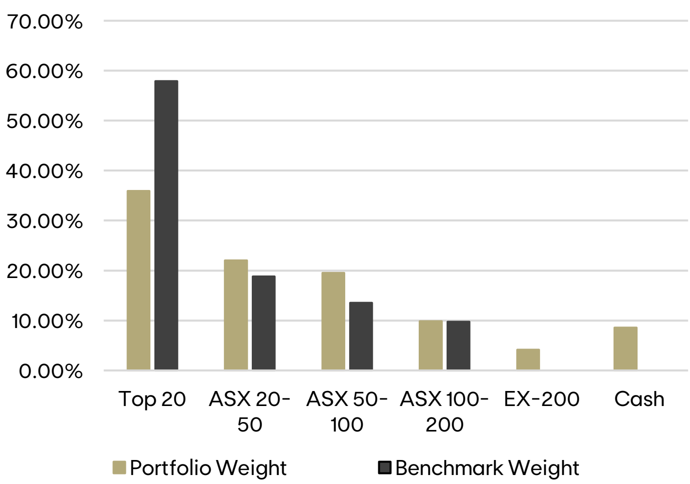
Source: Ellerston Capital.

SECTOR ALLOCATION



Source: Ellerston Capital.

MARKET CAPITALISATION



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Find out more

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Or visit us at ellerstoncapital.com

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