Ellerston Low-Vol Income Strategy Fund

Monthly Newsletter, October 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	$1.1714
Net Asset Value	$1.1685
Redemption Price	$1.1656
Liquidity	Monthly
No Stocks	31
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^	-0.85%	0.20%	5.37%	25.29%	11.04%	11.82%
Benchmark*	-0.10%	0.51%	6.34%	27.96%	8.41%	9.84%
Alpha	-0.75%	-0.31%	-0.97%	-2.67%	2.62%	1.98%

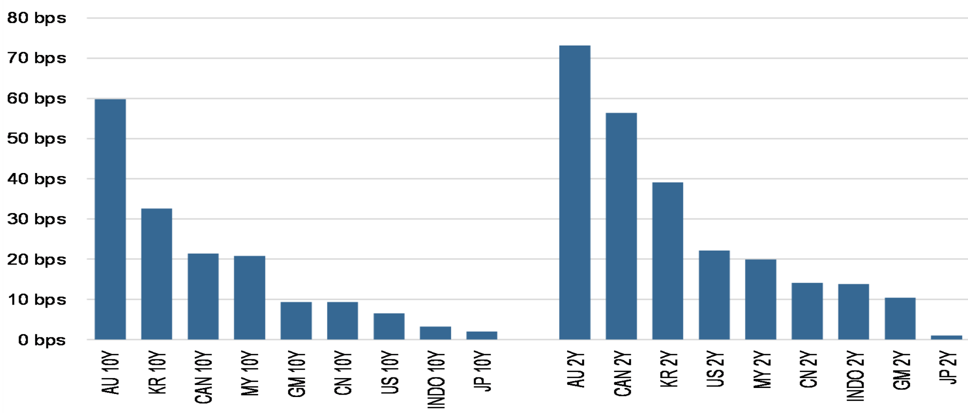
^ The net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance
*S&P/ASX 200 Accumulation Index.

PORTFOLIO COMMENTARY

Markets

October showed general optimism for global equity markets, particularly developed markets, as the DM World Index rose 5.5% and S&P 500 climbed 7.0% off the back of a strong US earnings season. Interestingly, we did not get the same follow through in Australia, with the ASX 200 declining 0.1% for the month. This meaningful underperformance was due to the market pricing in higher than expected inflation and tighter monetary policy, with Australian 10-year bond yields rising 59bps to 2.08%. Importantly, Australia led the surge in 2-year (front-end) yields moving materially higher, rising close to 60bps. This has been driven by concerns that Central Banks around the world will be forced to react more quickly on inflation than previously thought, thereby raising interest rates earlier.

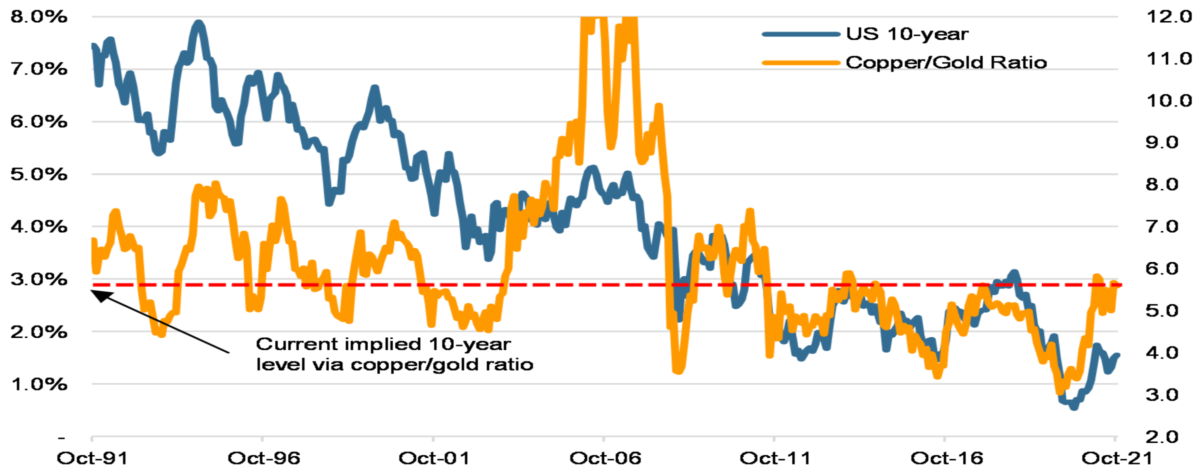
Key Global Bond Yields: 1m Change



Source: JP Morgan.

Furthermore, the current levels of the copper/gold ratio imply upside to current yields. We expect US 10-year bond yields will trend towards 1.80% by year end, before rising further in 2022. Copper is up almost 30% year to date and is expected to move higher as economies continue to recover.

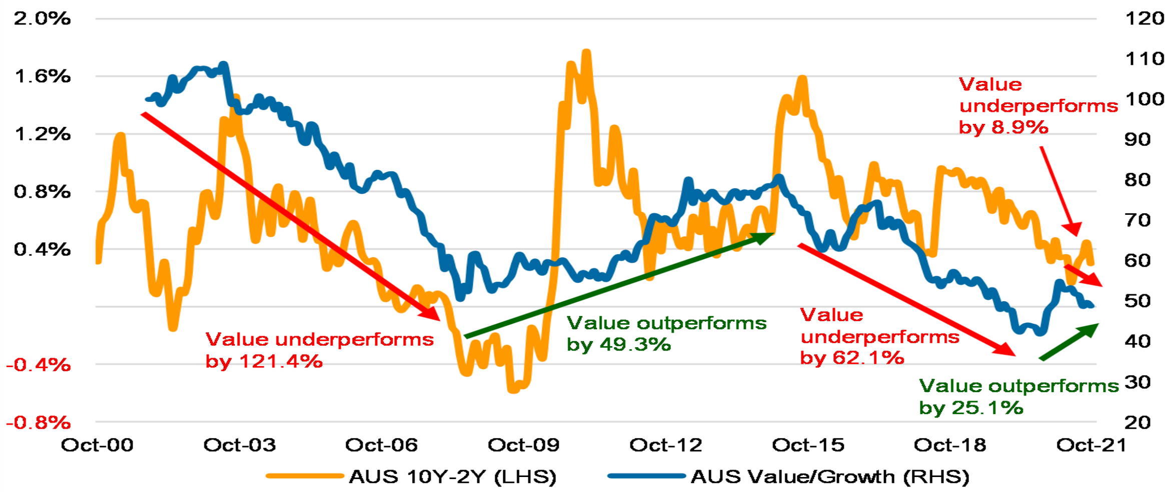
Copper/Gold Ratio vs US 10 Year Bond Yield



Source: JP Morgan.

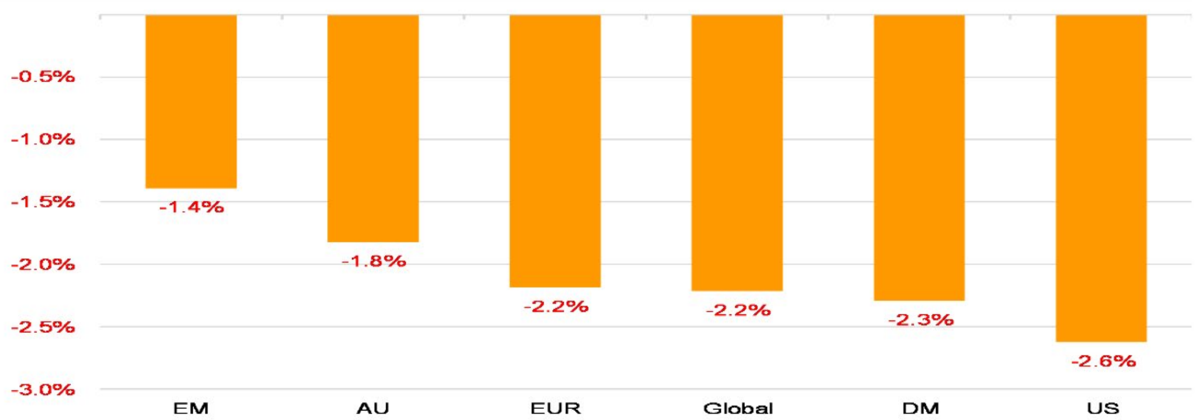
When looking at what styles of investment performed well during the month, the sharp 31bps flattening of the yield curve in Australia saw growth stocks outperform value stocks by 182bps. Over the past two decades there have been three distinct phases reflecting this correlation. Pre-GFC saw the curve flatten, resulting in Value stocks deeply underperforming. Healthcare was the primary outperformer. However, this event was also evident across the globe, with the US having the greatest variance in performance between Value and Growth stocks.

Australian yield curve vs MSCI Australian Value / Growth



Source: JP Morgan.

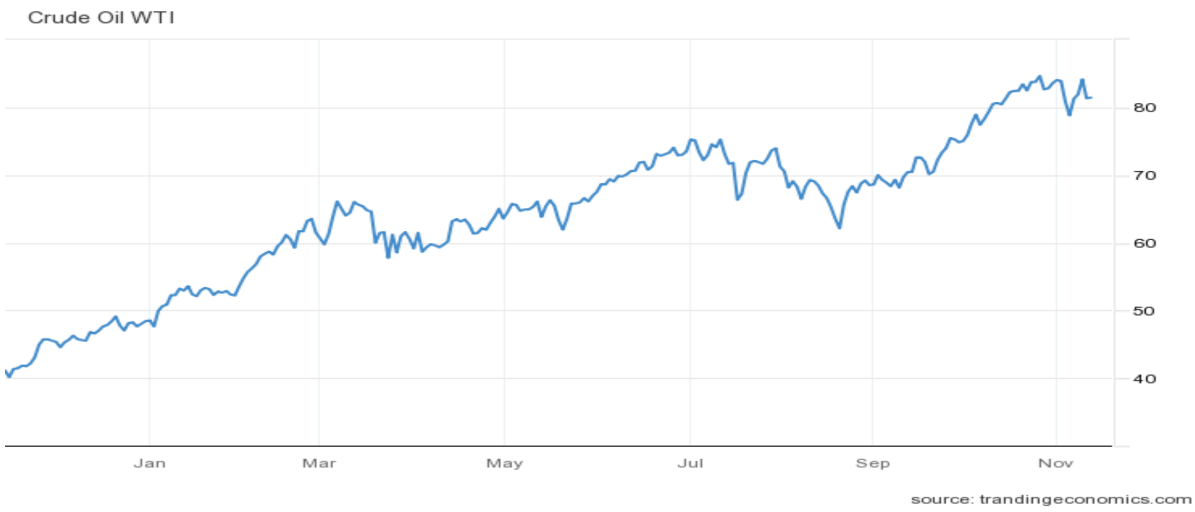
Global Markets – Value relative to Growth performance



Source: Bloomberg.

On the commodities front, Brent Oil rose US$6 per barrel to US$84.00 per barrel in October. Brent has continued to sustain prices higher than US$70/bbl despite the delta-variant concerns and additional supply coming onto market from China and OPEC. Oil prices have been supported in part by the longer than expected impact of Hurricane Ida to US oil production. Gold prices also rose, rising US$26 to $1,769 against the headwinds of Fed tightening expectations, higher yields, US Dollar strength and persistent net selling from ETF's. The move higher in gold coincided with real rates dropping to the lowest levels in about a month and break-evens revisiting their highs.

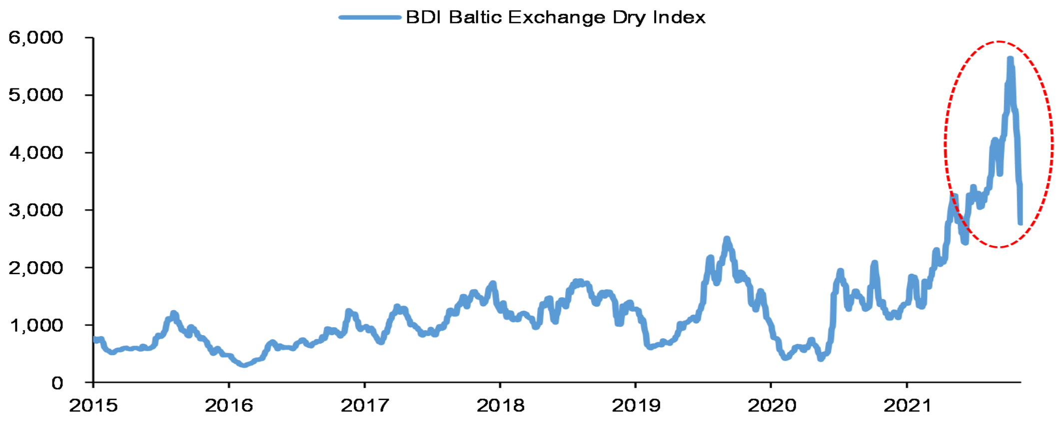
Iron Ore prices continued to correct as inventory at Chinese ports rose 6Mt to 140Mt, around 15% higher than a year ago. Inventories are now above average at 5 weeks of consumption. The demand profile continues to slow, with China daily crude steel production falling 20% vs 1H21 average. Iron Ore prices are likely to remain subdued for some time as demand weakens further and supply rises.



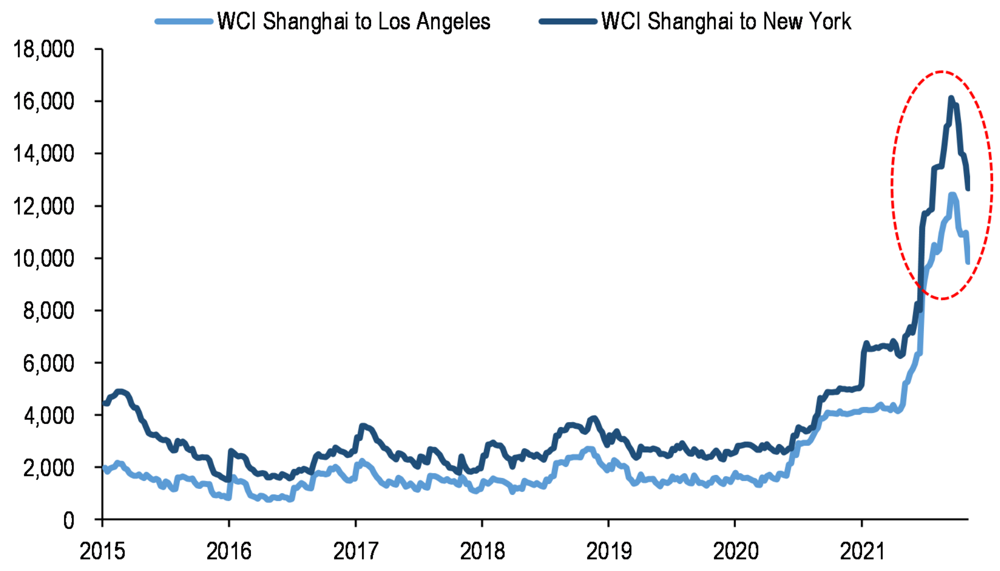
Source: JP Morgan.

On a positive note, there are signs that the global supply chain is showing signs of upstream improvement. This is evidenced by some easing raw material cost pressures, normalising shipping costs and a resumption of production in Asia. In China and Vietnam, full production in garments and apparel is set to resume by mid-November, suggesting labour shortages may be more transient by nature.

The chart below (Baltic Dry Index) provides a benchmark for the price of globally moving major raw materials by sea and shows a decent pullback in the last month or so, along with shipping freight rates between the US and China.



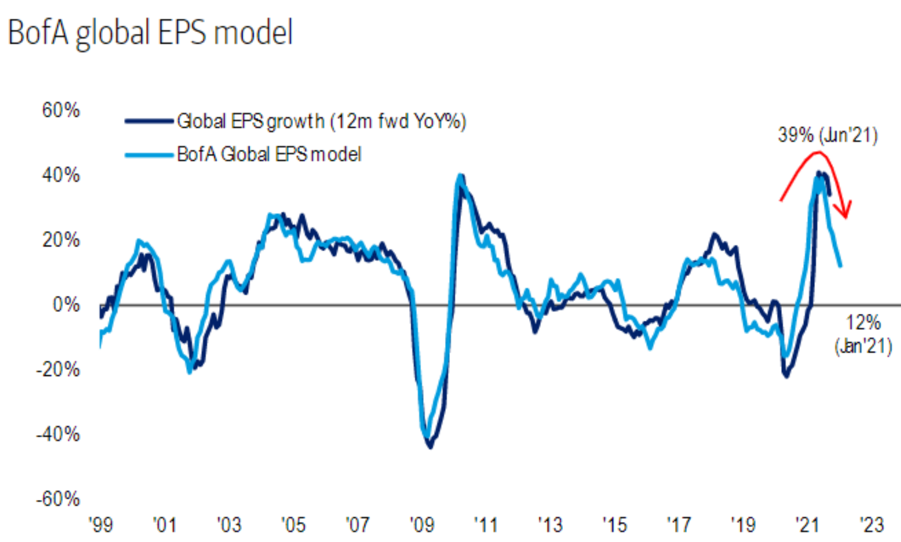
Source: JP Morgan.



Source: JP Morgan.

Global Earnings

Despite a very strong US Q3 EPS season, global lead indicators are pointing to a big deceleration ahead. When looking at the key lead indicators of China FCI, Asia exports, global PMI and the US yield curve, these Bank of America indicators are forecasting global earnings slowdown from 30% today to around 10% in January 2022. Furthermore, Asian industrial production growth is now at its lowest since November 2020.



Source: BofA Global Investment Strategy, Bloomberg, Haver

Asian Industrial Production growth YoY

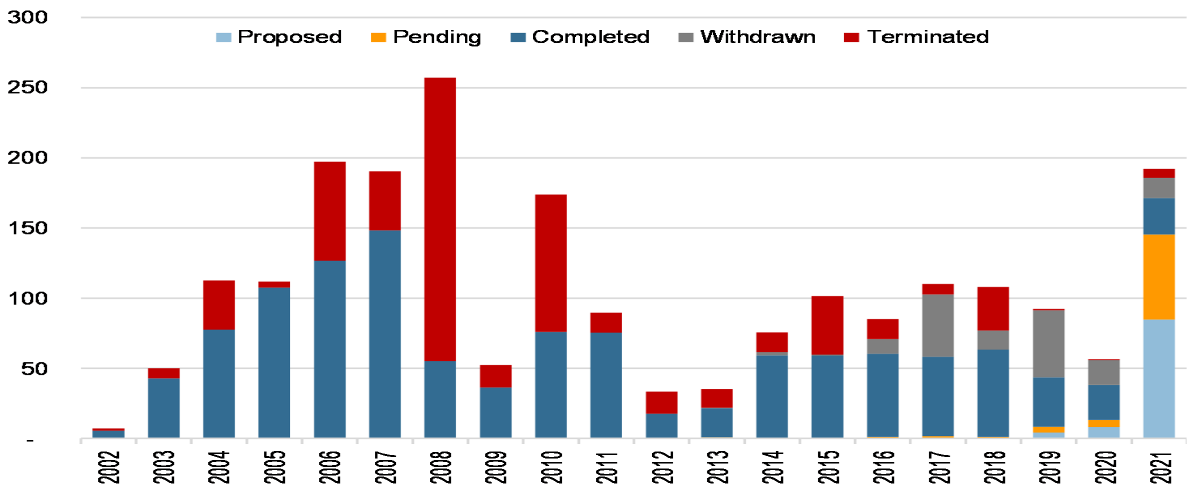
Source: BofA Global Investment Strategy, Bloomberg

In Australia, the market continued to challenge RBA's guidance regarding rate hikes this month. The 3-year bond yield jumped 49bps, following a stronger-than-expected 2.1% surge in the trimmed mean CPI. This marks the fourth largest monthly move up in the 3-year yield in the past 30 years, and the second largest move this decade. The RBA, however, chose not to intervene to maintain the Yield Curve Control (YCC) target, signalling a likely end to the YCC regime. As a result, economists brought forward their hike expectations from late 2023 to 4Q22.

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 A$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

A very strong Q3 reporting season in the US has been a key driver of markets as inflationary price pressures caused by supply side disruptions has been able to be passed onto the consumer, thereby preserving or increasing profit margins. This outcome is occurring around the developed world, including Australia. Despite this, an area of concern is the continued pace of rising bond yields due to higher inflation expectations. Yet the inflation tolerance of central banks and the maintenance of elevated global liquidity is likely to favour cyclical and gold stocks in the near term. Medium term, we expect the Fed is significantly behind the curve and the market will lose patience with the "inflation transitory" narrative by the Federal Reserve as we head through 2022. This is likely to result in a material lift in real yields, requiring a more defensive yield stance to be taken in the portfolio. In the short-term, the Fund strategy will likely perform broadly in line with the market as we are not able to be fully positioned for a risk-on, cyclical rally given the nature of our low volatility earnings and dividend strategy. The Fund strategy should be really well suited to economic conditions as we move further through 2022.

On a net basis, the Fund underperformed its benchmark by 75bps, achieving an absolute net return of -0.85% vs a benchmark return of -0.10%. Calendar year to date, the Fund has outperformed its benchmark by 282bps on a net basis.

From a sector and stock perspective, relative out performance came from Energy (owning Ampol) and Materials (not owning Rio Tinto, Fortescue Metals) whilst the biggest detractor to performance was being underweight Financials (not owning Macquarie Group) and Consumer Discretionary (owning Star Entertainment Group). Star Entertainment fell 18% for the month on the announcement that they will face a public hearing examining money laundering and infiltration by organised crime.

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.

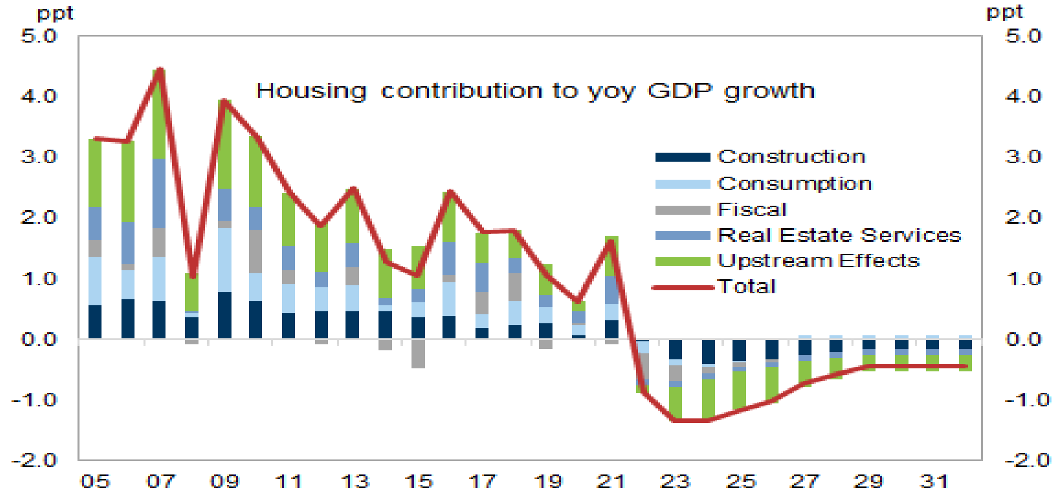
Portfolio Activity – Major Transactions

During the month we exited our position in Star Entertainment Group on ESG grounds following the public enquiry into money laundering. We also exited our position in Spark New Zealand and switched proceeds into Telstra Corporation due to Telstra having a brighter earnings growth and dividend trajectory than its New Zealand competitor. These stocks were replaced by the initiation of a new position in Iress Market Technology, following a substantial pullback in their share price post the withdrawal of the Equity Trustees bid. We also initiated a position in BHP Billiton given its more diversified exposure (particularly Energy) away from Iron Ore post our exit from Rio Tinto.

Macro News

US economic activity indicators continued to be mixed, with the manufacturing ISM ticking up to 61.1, above expectations. Non-farm payrolls rose just 194,000, well below expectations, and the unemployment rate fell to 4.8% as participation rates decreased. September Core-CPI rose 0.2% for the month, seeing the annualised inflation rate hit 4.0%. September retail sales rose 0.7% month on month, above expectations, but housing starts fell 1.6%, below expectations.

China economic data continues to look softer with the Caixin manufacturing PMI for September holding at 50.0 despite recent interest rate cuts. Of concern is that China is not 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 8.3% to 8.0%. The property market slowdown is a structural issue as well as a cyclical one and is still accelerating downward in 4Q. Looking into 2022, the macro narrative will stay challenging: China will likely grow below 5%, the lowest on record outside of crisis years, and its growth differentials relative to the world will be the narrowest in the past 4 decades. The economic headwinds are well-aired: a prolonged property market deleveraging, China's zero-COVID policy and its drags on consumption, normalizing export growth as the world re-opens, elevated upstream inflation that could hurt corporate profitability, and other structural issues, notably an aging population and high system-wide leverage. Furthermore, housing is expected to move from a major contributor to major detractor to economic growth from this year onward, as shown in the chart below.



Source: Goldman Sachs.

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

In Australia, CoreLogic dwelling growth moderated slightly further in September, with the smallest increase since January 2021. On a yearly basis, prices have still spiked 20.2%, the fastest since 1989. Residential building approvals rebounded, rising 6.8% for the month after 4 straight months of declines. Looking into 2022, dwelling commencements are likely to run at 220,000 for the year. Even stronger is the renovation market, with the value of alterations & additions up 42.4% for the year. Mobility restrictions in the more populous states saw employment fall worse than expected, down 146,000 for the month. This was the largest decline since May 2020. However, unemployment remains lower than the pre-lockdown rate of 4.9%. Finally, NAB business conditions dropped back sharply after two very strong months post the removal of some strict lockdown measures. October consumer sentiment (Westpac) fell back 1.5% month on month but still remarkably remains above average.

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. Ultimately, this should 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 over the medium term. In the short-term, the market is likely to continue its rally into year-end as excess global liquidity and favourable Central Bank rhetoric concerning inflation, supports markets.

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 FY22 dividend growth rate of investee companies held within the portfolio is comfortably above that of the market, at 23.6% and 8.9% respectively. The expected dividend yield of investee companies held within the portfolio is currently 3.2%, 73% franked vs the market dividend yield of 3.7%, 80% franked.

Portfolio Characteristics

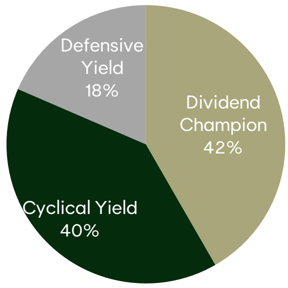
TOP 10 HOLDINGS

National Australia Bank Limited	8.5%
CSL Limited	7.6%
BHP Group	6.1%
Woolworths Group Ltd	5.9%
Westpac	4.5%
Tabcorp	3.8%
Ampol	3.8%
Dexus	3.6%
Amcor	3.5%
OZ Minerals	3.5%

KEY PORTFOLIO METRICS

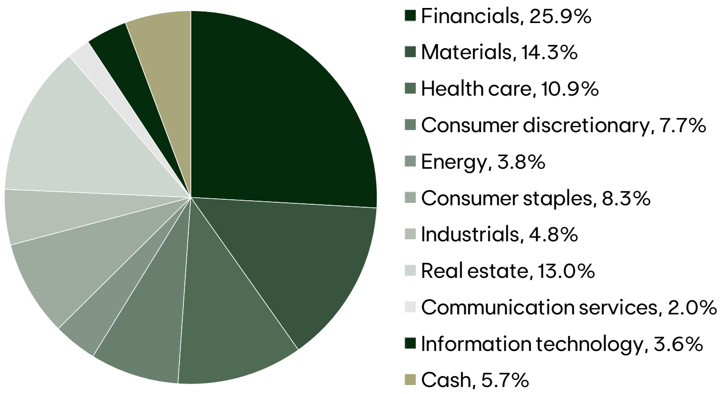
FY22(e)	Fund	Benchmark
Price/Earnings (x)	20.5	18.5
Dividend Yield (%)	3.2	3.7
Dividend Growth Rate (%)	23.6	8.9
Beta	0.88	1.00

PORTFOLIO YIELD EXPOSURE



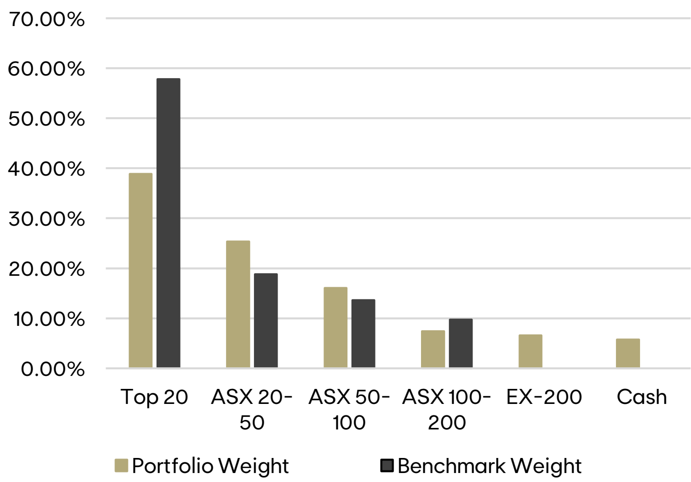
Source: Ellerston Capital.

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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