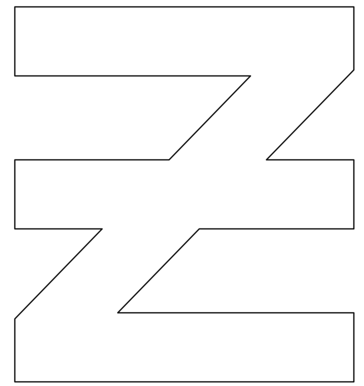
APIR Code: ECL0006AU



Ellerston Global Equity Managers Fund (GEMS) Class C

Monthly Newsletter, December 2021

Investment Objective

To generate superior returns for unitholders with a focus on risk and capital preservation.

Investment Strategy

The Fund provides investors with exposure to global markets through a long short equity strategy. The strategy overlays fundamental bottom-up stock selection with global macroeconomic and market outlook.

Key Information

Inception Date ^^	1 December 2009
Portfolio Managers	Ashok Jacob & Arik Star
Application Price	$1.8234
NAV Price	$1.8188
Redemption Price	$1.8143
Unit Pricing	Monthly
Management Fee	1.50%
Performance Fee	16.50%
Buy/Sell Spread	0.25% on application 0.25% on redemption

PERFORMANCE SUMMARY

Performance (Net)*	FYTD	CYTD	1 Year	2 Years (p.a.)	5 Years (p.a.)	Since Inception (p.a.) ^^
GEMS C	0.1%	22.8%	22.8%	30.3%	14.7%	13.5%

Source: Ellerston Capital.

* The net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance.

PERFORMANCE – Fiscal Year in Review

Fiscal Year to Date from July 1 to December 31, 2021**,** the Australian S&P/ASX 200 Index is up +3.8%, and the US S&P 500 Index is up +11.7%. **Your Fund is up net after fees +0.1%.**

Calendar Year to Date from January 1 to December 31, 2021, the Australian S&P/ASX 200 Index is up +17.2%, and the US S&P 500 Index is up +28.7%. **Your Fund is up net after fees +22.8%.**

For the Month of **December 2021**, the Australian S&P/ASX 200 Index was up +2.7%, and the US S&P 500 Index was up +4.5%. **Your Fund was up net after fees +1.7%.**

Performance:

Tale of two halves. We had a great first six months to the year and a relatively disappointing second half to the year. Our long book performed quite well through the year, adding 55% to gross performance, whilst our hedging/short side subtracted 25% from gross returns. While the risk adjusted return was compelling, we are continually focussed on optimising hedging strategies in order to mitigate material detraction from core performance.

Performance was broad based across the portfolio. Some highlights included our Uranium exposure throughout the year which contributed strong performance. Our cyclical exposure, purchased in late 2020 below economic replacement value generating material free cash flow, namely Olin and Alcoa, were also strong positive contributors to performance. Index strength was a real drag on the hedge book, as it masked some material weakness under the hood.

As absolute-return, fundamental stock pickers, we definitely had a more difficult time in the final 6 months of 2021 sourcing new ideas that had the asymmetric risk/reward return profile we demand. However, nothing is permanent in markets and with many individual stocks and subsectors performing much worse than the aggregate indexes would portend, the opportunity set is expanding rapidly. We are beginning to add to other stock-specific, idiosyncratic ideas at what we believe to be attractive levels. We look forward to sharing some of these ideas with you in the year ahead.

Positioning

Our portfolio comprises a suite of eclectic companies as well as a number of thematics. Some current thematics include:

Uranium – We remain highly constructive on the outlook for physical Uranium. When we began investing in the space two years ago the whole industry had been in a bear market for the better part of a decade, there was very little investor interest and the uranium miners were priced as though Uranium would never recover to its margin cost of production. At the same time, whilst the carbon-free benefits of nuclear energy as a source of baseload power were clear, we put limited weight on any sort of 'nuclear renaissance', given the embed political stance. Nonetheless, the risk/reward was remarkably compelling. In two short years, the landscape has changed dramatically. Accelerating in the past six months given the energy crises faced by Europe and Asia, there has seemingly been a groundswell of support pushing towards nuclear playing an increasing role as carbon-free baseload energy. This backdrop in conjunction with a move in the Uranium spot price from high US$20s/lb to mid US$40s/lb, has seen mining and exploration equities rise materially. As a result, broadly, we believe many of these equities now discount an implied Uranium price much closer to where we believe a contracting cycle will likely play out. Hence the risk/reward is no longer attractive. However, with the Uranium spot price still trading below marginal cost of production, we believe the physical commodity still represents a highly attractive payoff structure. Accordingly, we have iterated our Uranium exposure away from operating leverage towards spot price leverage over the second half of the year.

Energy – As noted in the above discussion around inflation drivers, we see an increasing risk of elevated energy prices in the years ahead as the typical supply responses are inhibited by various ESG-driven constraints and a greater respect of capital from the production companies. At the same time a number of energy stocks are discounting forward energy prices well below respective strip prices, which in many cases are already in backwardation.

Cyclicals – We retain a healthy exposure to a small select group of traditional cyclicals where we feel the market is broadly applying a simplistic framework that each of these businesses are at peak earnings and the return to trough earnings in imminent. In each case we believe the market is underappreciating the underinvestment that happened in the prior cycle and complete lack of typical supply side response to the current high commodity prices. So what is different this time? The impact of decarbonisation. In the case of Olin and Alcoa, both businesses are operating in industries where potential supply side capacity has declined versus the same time last year.

Gold – We maintain a core exposure to gold and gold equities. Despite having a benign 2021, we are happy owners given our longer-term views on where real rates must go for sovereigns to continue to carry their highly elevated debt loads. Given Gold had a much quieter 2021 compared to the years prior, we have optimised the exposure to take advantage of some of the cheaper implied volatility. This benefits both the capital efficiency of the position as well as increases leverage to the upside should gold move aggressively higher.

Outlook

Buckle up. 2022 has kicked off with extreme volatility and we don't see any reason for this to subside in the near future. After touting inflation as 'transitory' for much of 2021, the Fed did away with this term in late November 2021 and has already pivoted five times in its proposed tightening trajectory. Each pivot incrementally more hawkish than the last, the market has now priced in a March 2022 hike (including a 25% chance of a 50bp hike), 4.8 hikes in 2022 and balance sheet unwind to begin in Summer/Spring, which may include outright asset sales. As such, the flowing liquidity and ultra-loose financial conditions that have inflated risk asset prices for more than a decade, have now begun to reverse.

The onset of COVID-19 led to an even more extreme implementation of the post GFC-era, zero interest rates and Quantitative Easing (QE) playbook. Further, extreme monetary policy settings were accompanied by an aggregate fiscal stimulus package that made Obama's infamous US$700bil TARP program look like penny change. The biggest beneficiary of these extraordinary policy settings have been long-duration technology stocks – the bigger the 'TAM', the better! The further away the 'cash flows', the better! Spreadsheets say those businesses are worth more in such an environment. Stock narratives, momentum, fund flows, investor FOMO, etc. do the rest from there. However, as the tide of COVID-19 response policies begins to turn and go out, the pain is already beginning to be felt, exemplified by Cathie Woods' ARKK ETF down circa 50% from its February 2021 high.

This is all known. So the question is where to from here? There are entire generations of investors which have been continually conditioned to always 'buy the dip' following any weakness in US equities and particularly in US technology stocks. However, whether known or not, this approach always rested on the condition that inflation was not a risk to the economy. The US will begin 2022 with CPI running at circa 7%, <4% unemployment , >4% wage growth and an oil price that continues to march higher post its March 2020 negative price episode. The 'Fed Put' seems as far away as it has in over two decades.

The Fed cannot raise rates while it has QE running, hence the shortening of the taper from June to March. Any earlier ending would have been too clumsy and reeked of panic, hurting the credibility of the Fed. However, inflation has arrived. We now have a painful six week wait while markets fret over the coming rate rises. Can the Fed pivot backwards on tapering? Not without destroying its credibility. On rate rises? Not without inflation suddenly falling. It seems like a perfect storm, the exact opposite of what we saw for the last ten years especially the last two.

The key question for 2022 will be how does growth and inflation fare as the Fed embarks on its trajectory of rate hikes and balance sheet reduction. The best scenario markets can hope for, is one in which, inflation fades from its current circa 7% level to something more palatable and growth remains robust. In such a scenario, we would expect our cyclical exposure to do exceptionally well given these businesses are being priced for an almost immediate ending of the economic cycle and return to trough earnings. The worst scenario for markets is almost surely one in which growth fades and inflation pressures remain stubbornly robust even in the face of rate hikes and balance sheet reduction. Stagflation. The Fed will be boxed in, forced to choose between inflation or recession. In the event that growth and inflation both fade quickly over the next 6-12 months, one can reasonably expect the Fed to pivot and return to the policies of the prior decade. Although given inflation is a lagging economic indicator, the sequencing of this scenario is likely to involve further pain before the Fed put is struck. In almost any scenario the immediate outlook for long-duration tech looks challenged, but expect huge counter-trend moves throughout.

Inflation is a perennially tricky topic, driven by a range of complex underlying drivers. So what could cause inflation pressures to remain stubbornly robust? We have no great insight as to where inflation ultimately prints in the months and years ahead, but a few factors that we are mindful of are worth noting:

- Energy Prices: What does a perfect storm of structural underinvestment in fossil fuels look like? How about, prior decades of poor returns on capital employed, including a US shale boom in which billions upon billions of debt and equity capital were effectively lit on fire, a negative oil price, a multi-year pandemic impacting various components of demand and an accelerating ESG movement, elevating the industry's cost of capital and aggressively advocating for reduced investment. In the short to medium term, this would appear to be a fairly potent cocktail for structural underinvestment on the supply side. In a world that physically cannot decarbonise demand anywhere near as quickly as the political ideologies desire, the stage is set for higher energy prices. Further, the situation can get much worse, if the traditional supply response to the signal of higher prices is fundamentally impaired. In the modern world, energy is life. Higher energy prices are textbook cost-push inflation. If energy prices remain elevated or worse still, grind higher, all else equal, this is a recipe for secular inflation.

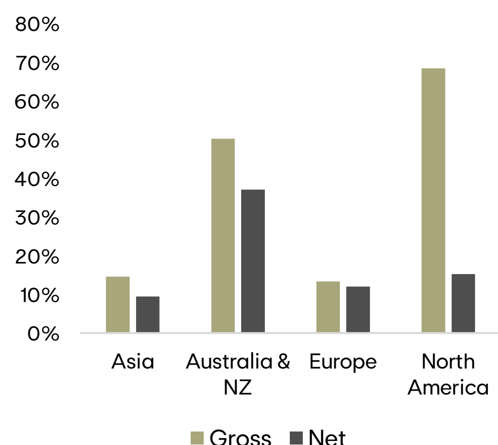
- Deglobalisation: Whilst international trade data shows the rise of globalisation peaked in the late 2000's, the events of the pandemic, in conjunction with the accelerating global focus on emissions reduction will likely pave the way for an acceleration of deglobalisation trends in the years to come. Globalisation was an inherently disinflationary force, largely underpinned by labour cost arbitrage. The pandemic exposed the fragility of global supply chains optimised for decades in the name of efficiency at the cost of resiliency. A greater focus going forward on having a greater proportion of critical supplies available locally as well increased supply chain resilience are inflationary trends. Further, the greater focus on emissions reduction should reduce exporting of emissions intensive products, as countries look to meet their sustainability goals. At the top of this list is China, where for example we've already seen episodes of rationing production of energy-intensive metals such as aluminium and magnesium.

- Wage Inflation: Hard data, survey data and countless anecdotes suggest that labour markets are much tighter than almost anyone forecast they would be 12-18 months ago. Commensurately, we have seen some decent strength in US wage inflation. Questions remain though – is the depressed labour participation rate a sign of too much stimulus and lingering COVID health-risk concerns, that will pass in time? Or is it structural? After a number of decades of little to no real wage growth, will this cycle be different given the starting point?

In summary, the outlook for markets in 2022 would seem as uncertain as ever, and will be particularly reliant on how the economy holds up to an almost polar opposite policy backdrop versus the prior two years. However, with that said, as absolute-return, fundamental stock-pickers at heart, we're increasingly encouraged by the opportunity set in front of us as we pick through some of the pockets of distress.

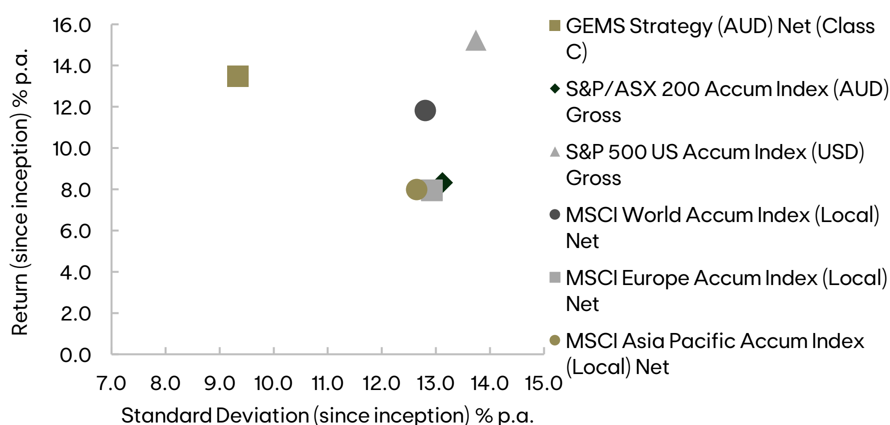
PORTFOLIO CHARACTERISTICS

Market Exposure as a % of NAV



Source: Ellerston Capital.

GEMS Strategy Performance & Volatility^



Source: Ellerston Capital.

Top 10 Holdings (Alphabetical, Long Only)

- ALCOA CORP
- CELLNEX
- CEMEX
- GENERATION DEVELOPMENT GROUP
- GRAINCORP
- MAGGIE BEER HOLDINGS
- MAWSON INFRASTRUCTURE GROUP
- MONEY3
- OLIN
- TESCO

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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**

^ Actual performance for your account may vary from that set out in this newsletter and will vary for investments made in different classes, or at different times throughout the year. Some performance data is estimated and preliminary and subject to change.

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