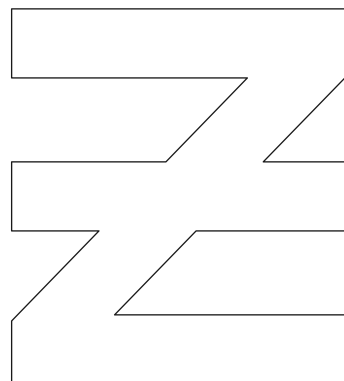


Ellerston Low-Vol Income Strategy Fund

Monthly Newsletter, January 2022

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 Kourtis
Application Price	$1.1357
Net Asset Value	$1.1329
Redemption Price	$1.1301
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	FYTD	1 Year	2 Years (p.a.)	Since Inception (p.a.)^^
Net^	-5.04%	-1.27%	-0.96%	15.84%	5.61%	10.18%
Benchmark*	-6.35%	-4.30%	-2.75%	9.44%	2.97%	7.18%
Alpha	1.31%	3.03%	1.79%	6.39%	2.64%	2.99%

^ 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

Investors endured a white-knuckled, volatile start to the New Year, brought on by a more hawkish Federal Reserve (Fed), higher inflation indicators and softer key global economic data. This saw real yields rise, ending with red ink across equity markets in January. The US market closed down 5.2%, European markets posted a 2.8% fall, whilst Asian markets were very weak, although Hong Kong was one of the few bourses in positive territory.

The Australian share market was not spared, falling in line with the US and Asia, with the S&P/ASX 200 Accumulation Index closing down 6.35%, its worst month since March 2020.

USA

The major news was the Fed's very hawkish tone at its meeting late in the month. Fed Chair Jerome Powell jawboned the market for a rate hike sooner than previously flagged, stating there was "quite a bit of room to raise rates without threatening the labour market". The employment cost index, a measure cited by Powell in December as a key reason for the central bank's pivot to a more aggressive stance on inflation, rose 4% in the year through December, the most in two decades.

Economic indicators during the month were mixed, with the January ISM manufacturing index down 1.2 to 57.6, slightly ahead of consensus. December non-farm payrolls of 199k were again below consensus at 450k, as supply bottlenecks and historically weak support from seasonal adjustment contributed to the miss, however, the unemployment rate ticked down to a new pandemic recovery low of 3.9%. The December core CPI at +0.6% MoM (+5.5% YoY) was the biggest annual growth since February 1991, while the headline number at +6.8% YoY, was the highest level since June 1982. Finally, US December retail trade fell 1.9%, worse than expected and November was revised down. Considering that the sales numbers are not adjusted for inflation, the data pointed to a slow ending to what had otherwise been a strong 2021, in which sales rose 16.9% from the pandemic-scarred 2020.

Unsurprisingly, US equities tanked, with the Nasdaq Composite Index taking the brunt, down 9.0% (but well off its intra-month closing low of 13,352 recorded on the 27th January, by 7%), followed by the S&P 500 down 5.2% and the Dow Jones Industrial Average closing down 3.2%. Reporting season kicked off with half of the FANMAG reporting. Apple and Microsoft beat by 11% and 7% respectively, driving their stock prices up 7% and 3% on the day. Netflix also beat on earnings but guided to lower subscription growth for Q1 2022, which king hit its share price, down 22% on the day.

Europe

The Eurozone economic recovery ran out of steam this month as renewed restrictions imposed to contain the Omicron variant put another dent in bloc's dominant services activity, just as input prices continued to soar. The Eurozone Composite PMI for January was down to 52.4 from 53.3, to an 11 month low due to a drag from services caused by COVID-19 induced labour shortages. However, the Manufacturing PMI rose to a 5 month high of 59.0, comfortably ahead of forecasts.

The Euro STOXX 50 Index finished the month down 2.8%. Among the major exchanges, France's CAC 40 fell 2.1%, Germany's DAX was 2.6% lower and the UK's FTSE 100 was the standout, bucking the trend and closing up 1.1%.

Asia

China's exports remained strong (+20.9% YoY), manufacturing and infrastructure investment improved, while pandemic restrictions continued to depress retail sales. Q4 GDP growth slowed to +4% YoY, but was much better than expected, December YoY Industrial production was up 4.3% versus 3.8% in the previous month and FAI rose 2.0% YoY compared to November's woeful 2.2% decline.

Asian equity markets were generally mixed, with the Hang Seng up 1.7%, India's SENSEX down 0.4%, the Nikkei 225 6.2% lower, China's SSE fell 7.7%, whilst the laggard was the Korean KOSPI, down 10.6%.

Commodities

Iron ore bounced another 19% to US$142/tonne, taking a lead from China's 22% increase in December steel production and Brazil's weather impacted shipments. The Brent oil price ended 17% higher at US$91 per barrel, impacted by geopolitical tensions in the Ukraine and supply side concerns. The base metals complex was stronger, with the major metals aluminium and nickel both up 9%, however copper lagged, down 2%. Coking and thermal coal prices continued rising 24% and 41% respectively to record levels, as cold weather and sky high gas prices continue to add support. Gold was 2% weaker at US$1,800 per ounce as higher inflation prints were offset by significantly higher bond yields.

Bonds

US 10-year treasury yield rocketed 27bps to 1.78% in January and the Australian 10-year bond likewise rose 22bps to 1.89%. The RBA announced its decision to leave its official interest rate target on hold at 10bps and chose to stop purchasing bonds. It also flagged that the Quantitative Easing (QE) cessation move is not linked to near-term rate hikes.

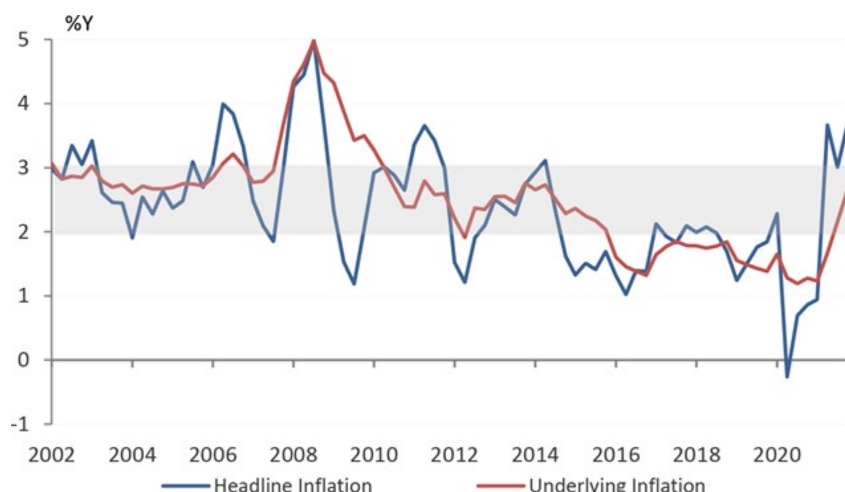
The AUD was 2% lower at US$0.71, given the strength in the greenback, driven by higher US interest rates.

Australia

In January, **the S&P/ASX 200 Accumulation Index finished 6.35% lower**. The Energy sector (up 7.9%, driven by Woodside Petroleum's 14.3% rise) was the highest contributor to the Index's performance, adding 23bps, followed by Utilities (up 2.6%), contributing 3bps and then Materials again (up 0.8%, with the rest of the sector offsetting BHP rise of 11.7%) adding 2bps. The bottom three contributing sectors were Financials (-192 points being the worst), followed by Health Care (-123 points) and Information Technology (-78 points). The best performing sub-index was again the ASX 200 Resources Index, which finished up 3.0%, outperforming the broader benchmark, whilst the major underperformer was the ASX 200 A-REIT Index, which closed down a whopping 9.5%.

For the month, the top stocks that made a positive contribution to the Index's return were: BHP Group (+59 points), Rio Tinto (+20 points), Woodside Petroleum (+13 points), Santos (+11 points) and Fortescue Metals (+4 points). Conversely, the top five stocks detracting from the Index's performance were: CSL (-66 points), CBA (-59 points), Macquarie Group (-36 points), Wesfarmers (-34 points) and NAB (-27 points).

In economic news domestically, the labour market tightened further in December with 65K jobs added and the unemployment rate fell to 4.2% from 4.6%. Inflation moved higher in the December quarter with the headline CPI at 3.5% YoY and the "underlying" trimmed mean spiked to 2.6% YoY. This level was above the RBA's forecast and towards the upper end of its target band.



Source: Morgan Stanley.

COMPANY SPECIFIC NEWS

The Market Hits

Champion Iron (CIA +18.6%) / BHP Group (BHP +11.7%)/ Rio Tinto (RIO +11.4%)

These stocks all caught a major tailwind from the higher iron ore prices which rallied another 19% during the month. Given Champion's financial leverage as a result of its high cost Canadian operations, not surprisingly, CIA was the star outperformer.

Beach Energy (BPT +17.5%) / Woodside Petroleum (WPL +14.3%) / Santos (STO +13.2%) / Worley (WOR +8.7%)

Global energy shares were amongst the best performers in January and Australia was no exception. Domestic energy names were all beneficiaries of the material rise in oil prices during the month, with Brent up 17% to US$91 per barrel. Engineering company WOR, whilst not a hydrocarbon producer, still derives around 50% of its revenue from the energy sector, resulting in increased activity for WOR, given the improved industry profitability driven by much higher oil prices.

AGL Energy (AGL +15.6%)

AGL is of course heavily leveraged to base-load electricity pricing. The recent strong rally in wholesale forward prices has resulted in renewed investor interest ahead of its proposed demerger and its recent fall to a 22 year low in November.

Unibail-Rodamco-Westfield (URW +11.9%)

Whilst Australian REITS underperformed the local market, global REITS outperformed and dual listed URW benefitted from the 9% rise in the French listed company and weakness in the A$.

G.U.D. Holdings (GUD +8.4%)

On 30 November, auto parts, pumps and water pressure systems manufacturing and distribution company, GUD's acquired AutoPacific Group, the market leader in the fast growing 4WD towing category for $745m. The acquisition was partly financed by a deep discounted $405m equity raising which weighed heavily on the stock in December (-5.5%). The stock price reacted positively in January to a number of belated broker earnings and recommendation upgrades, highlighting the positive strategic move post the acquisition.

The Market Misses:

PointsBet Holdings (PBH -31.1%)

Against the backdrop of a brutal sell off globally in tech, i-gaming and online entertainment shares, PBH's share price performance disappointed this month, though, nothing stock-specific. Across the globe, sports betting/gaming stocks have felt the brunt of a swift change in investor sentiment, shifting 6 months ago from a very constructive view of the opportunity to capture share in an estimated US$50bn market. Investors are now taking a much shorter-term view which scrutinizes quarterly market share movements and levels of marketing spend, as the headwinds of the hyper-competitive environment to acquire customers persists. Despite securing a New York license, gaining regulatory approvals in Pennsylvania, recording a 34% YoY handle growth in Australia and delivering on a number of other key deliverables (including group net win up 73% YoY), PBH's solid 2Q update barely moved the needle on its share price. PBH's cash burn during Q2 was relatively high, but included a $25m payment for New York access and higher up front marketing spend in Australia to push the Spring Racing Carnival. We would expect a materially lower figure next quarter and with over $500m of corporate cash on the balance sheet, PBH should be able to weather the storm over the medium term.

Megaport (MP1 -27.8%)

Former tech darling, MP1, sold off in January, again reflecting the pressure on tech, specifically profitless tech, and a mixed trading update. Despite maintaining its revenue trajectory, disappointingly, margin improvement was delayed as a result of a transition in business model with higher costs, which effectively pushed break even expectations out by another year. The company also capped off the negative month with a second rejection from shareholders on directors' pay.

Pro Medicus (PME -27.8%)

PME, a leading imaging IT provider, shed 13% in the first week of trading in 2022 on no specific company news, weighed down by the wider healthcare sell off spurred by the Omicron variant's impact on the medical services sector.

Pinnacle Investment Management (PNI -27.7%)

Listed investment managers were under severe pressure, as markets corrected, but PNI fell significantly more. Investors questioned its prospects going forward, given its "growthier" affiliates were being impacted by the current market tilt away from growth stocks and rotation back into the resources sector, especially the EV cohorts.

Afterpay/Block (APT/SQ2 -27.1%)

Following the all scrip implementation of the scheme of arrangement with US company Block (formerly known as Square), APT ceased trading on 19th January, with the commencement of trading of the new Block CDI's under the symbol SQ2 on the 20th January. Shareholders who stayed for the long haul, since the merger announcement on 2 August, have taken a ~27% hit during the month and have suffered a mind-snapping 56% drawdown from the August closing price of $137.59 per share. The newspaper banner of the largest ever Australian M&A transaction at $39bn (now $18bn) may possibly go down in the history books as the worst local takeover ever, highly reminiscent of the AOL-Time Warner merger in the dying days of the Tech Bubble in 2000, for those who were around back then.

Zip Co (Z1P -27.0%)

Buy now, pay later (BNPL) stocks came under further pressure globally during the month, sparked by the market meltdowns, with the prospect of higher rates particularly impacting the "profitless growth" areas of the market. Z1P shares fell in line with APT/SQ2.

Wisetech Global (WTC -22.7%)

Technology stocks were in the firing line as the Fed's pivot on rates and liquidity dragged markets down, with WTC being no exception.

Imugene (IMU -22.5%)

Despite positive developments from the European Patent Office and an announcement of a new clinical trial supply agreement with Swiss pharmaceutical company, Roche, IMU, the recent immune-oncology company addition to the ASX200, sank in January. The stock was caught in the healthcare sell off and fuelled further by the retirement of well-respected Chief Medical Officer, Dr. Rita Laeufle.

Tyro Payments (TYR -21.7%)

A combination of Omicron impacts on its merchant terminals business, the market's pivot away from technology stocks and the company's recent AGM downgrade lingering, dragged the stock down.

Altium (ALU -21.0%)

No specific news on Software developer ALU during the month, but again, the stock prices of technology sector were down across the board. Those who were waiting for another bid, after the company rejected the Autodesk offer in July, are still pondering.

FUND PERFORMANCE

In a brutal period for global financial markets, the Fund was down 4.80% for the month, outperforming the benchmark return of -6.35%, and continuing to show resilience for the FYTD by being down a modest 0.26%, versus the benchmark which has fallen 2.75%.

In terms of factor analysis for the month of January, Value significantly outperformed. Energy (+7.9%), led by Woodside Petroleum up 14.3% and Santos up 13.2% with the tailwind of 17% higher oil prices, was the best performing sector. Followed by Utilities (+2.6%), with AGL up 15.6% and Origin Energy up 7.3% and Materials (+0.8%) driven by BHP +11.7% and Rio Tinto up 11.4%, were particularly favoured.

BHP has been one of the few bright spots in the Australian equity market in the early part of 2022 with a +11.7% absolute and +18% market-relative for the month. Only a handful of times in the past decade or so have we seen BHP outperform the broader market by more double digits in a single month and in January, it was right up there with the biggest of those readings. Furthermore, BHP has significantly outperformed the market for the third month in a row (+31% cumulative alpha since the start of November), simply astonishing.

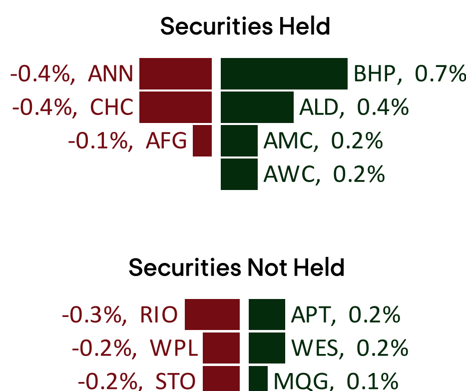
Returns[1] (%)	*Gross*	*Benchmark**	*Excess*	*Net Return*
1 Month	-4.80	-6.35	1.55	-5.04
3 Months	-0.85	-4.30	3.45	-1.27
2022 FYTD	-0.26	-2.75	2.49	-0.96
1 Year	17.12	9.44	7.67	15.84
2 Years (p.a.)	6.74	2.97	3.76	5.61
Since Inception (p.a.)	11.33	7.18	4.15	10.18

Past performance is not a reliable indicator of future performance.

[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.

Month of January Attribution



Source: Ellerston Capital.

The main positive contributors to this month's performance were overweight positions in: BHP Group (BHP +11.7%), Ampol (ALD +0.2%), Amcor (AMC +1.8%) and Alumina (AWC +1.1%).

Amcor (AMC) continues to execute exceptionally well and deliver results for its shareholders despite a persistently challenging operating environment.

Zero weight positions that also helped included Afterpay/ Block (APT/SQ2 -27.1%), Wesfarmers (WES -11.1%), and Macquarie Group (MQG -10.6%).

The main detractors to performance for the month were overweight holdings in: Ansell (ANN -15.1%), Charter Hall Group (CHC -18.6%) and Australian Finance Group (AFG -18.5 %).

Not holding the following shares that outperformed the broader market and somewhat constrained returns were: Rio Tinto (RIO +11.4%), Woodside Petroleum (WPL +14.3) and Santos (STO +13.2%).

FUND ACTIVITY

Whilst many stocks and sectors have re-rated significantly from their March 2020 pandemic lows, we continue to seek, and more importantly are still finding plenty of opportunities that we believe are highly compelling, are mispriced and should deliver over the medium term.

We have been repositioning the Fund to better suit current conditions, aiming for higher dividend growth and enhanced yield. In January, we introduced GrainCorp, having pulled back on market concerns of too much rain, however, we are confident that the company will extend its current purple patch into FY23. GNC should deliver solid profit growth and higher dividends should flow. Also, Suncorp Group (a beneficiary of higher interest rates) was added ahead of the February reporting season, where market expectations were low going into the result, however we expect the company to deliver with its 1H results as GWP's harden. A few new higher sustainable dividend yielding names were also added, including GPT Group, Medibank Private, Stockland Corporation and Transurban Group and we also further strengthened the existing holdings in Ampol, Ansell and Alumina. To fund the above additions, we exited Link Administration (under takeover and was trading above the cash offer price), Peter Warren Automotive, QBE Insurance, Tabcorp Holdings, Telstra and Westpac. Plus we continued to trim Charter Hall Group, Goodman Group and Woolworths.

The dividend yield of the Fund has now been enhanced to 4.5% with far superior DPS growth.

NEW STOCKS ADDED	STOCKS EXITED
• GrainCorp	• Link Administration Holdings
• GPT Group	• Peter Warren Automotive Holdings
• Medibank Private	• QBE Insurance Group
• Stockland Corporation	• Tabcorp Holdings
• Suncorp Group	• Telstra Corporation
• Transurban Group	• Westpac Banking Corporation

INCREASED	DECREASED
• Ampol	• Charter Hall Group
• Ansell	• Goodman Group
• Alumina	• Woolworths Group

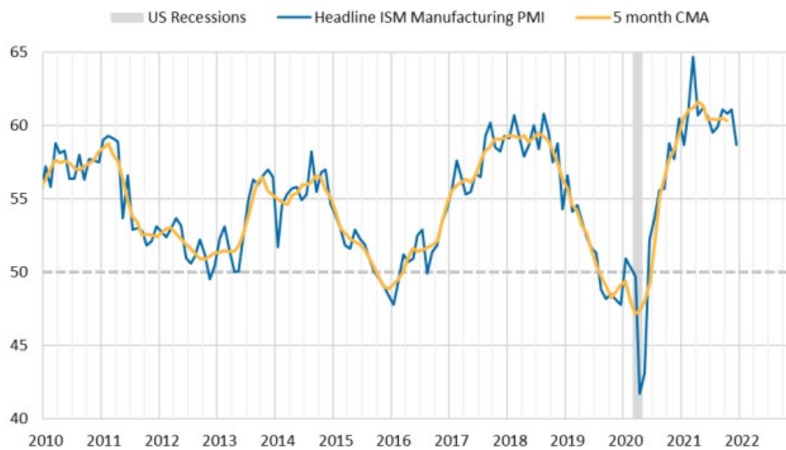
FUND STRATEGY AND OUTLOOK

A lot has happened in financial markets and in the geo-politics since our last post, so we continue to aggressively pivot where necessary as discussed in the Fund Activity section.

The biggest underweight from a risk perspective is to the Financials sector, which FYTD, has proved fruitful. Whilst the pending reporting season might spark a temporary relief rally, with further net interest margin pressure to come and a Federal election looming (and the prospect of a Labour victory), we remain cautious and watch with keen interest. NAB remains our pick of the bunch where we remain overweight.

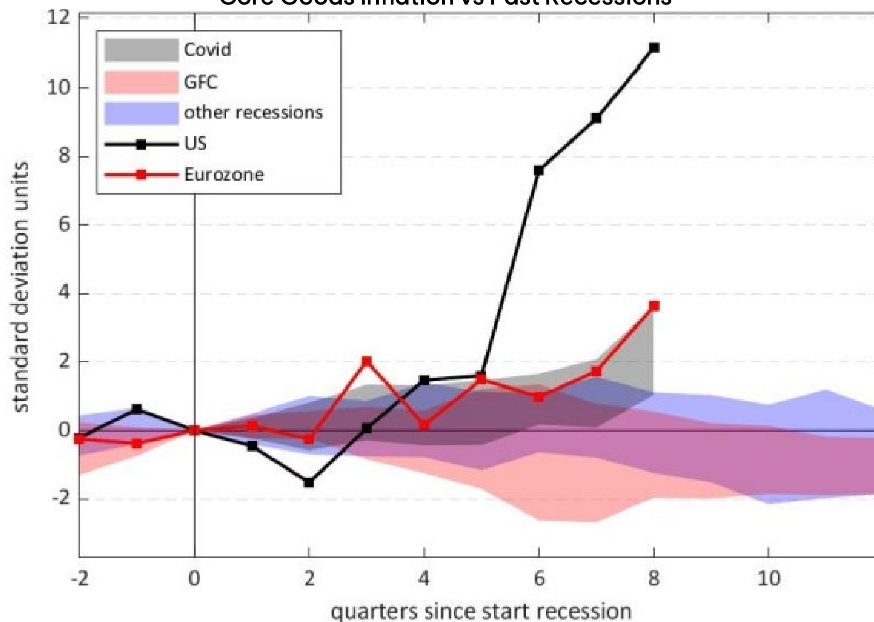
In the US, we are at the half-way mark for 4Q reporting season and 46.5% of the S&P 500's market cap have reported, with 72% of companies beating estimates. Expectations currently are for revenues and EPS growth of 14.0% and 22.5% respectively. Price actions post results have been relatively muted compared to the last couple of quarters. Companies beating on both revenues and EPS are outperforming the market by 0.3% vs. an average of 1.8%, while stocks missing on both are underperforming by -2.0% vs. -3.1%.

The ISM Manufacturing PMI captured the boom in goods spending during the initial phase of the pandemic and has proved resilient, but there is a risk of a mid-cycle slowdown as spending shifts back towards services as economies progressively normalise.



Source: Macquarie Research.

This has been reflected in the massive goods inflation, whereas services inflation has been more in line with past post-recession outcomes.



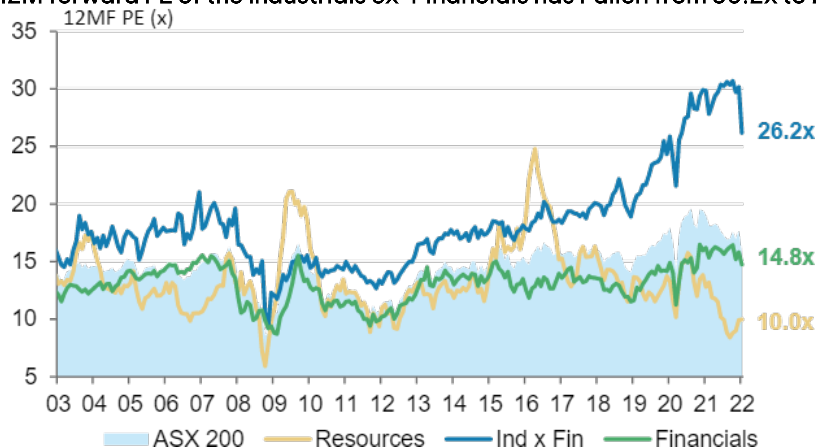
Source: UBS.

The US Federal Reserve has struck a very hawkish tone at its first meeting of the year with rate rises to be sooner rather than later. The Fed is highly motivated to curb an inflation rate running at the hottest levels in almost 4 decades and seems unlikely to be dissuaded by the recent share market volatility. Market observers now see lift-off in March as a certainty with expectations having shifted from four hikes in 2022 to five. The Fed also released a paper outlining principles to start "significantly reducing" the bond holdings on its balance sheet, without nominating a specific time frame for this.

The impact and effects of the Omicron variant continue to be felt, however, the medium-term outlook for Australia's post-pandemic recovery remains constructive with solid consumer and corporate balance sheets and a broad reopening pulse yet to be fully executed. The oil in the ointment is the ultimate tightening of financial conditions as the RBA joins other central banks in lifting rates and withdrawing liquidity. The upcoming Federal election outcome and subsequent policy settings will also be important.

Valuations have in the past 3-5 years been supported by historically record low bond rates and earnings growth. In January, for the first time we started to see the "expensive" side of the Australian market, the Industrials ex-Financials, subjected to a material de-rating.

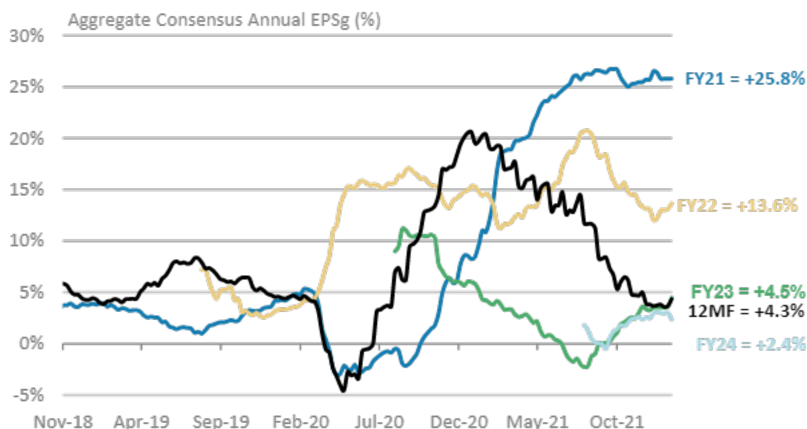
The 12M forward PE of the Industrials ex-Financials has Fallen from 30.2x to 26.2x



Source: Morgan Stanley Research.

It goes without saying that higher rates as signalled by key central banks will act as a major headwind to the returns in key segments of the market, with earnings continuing to be the key driver. Earnings momentum is relatively better in Industrials and Materials, where the Fund is well positioned. As emphasised for the past few months in previous communiques, the high flying tech sector, which has started to sour, will be especially vulnerable against this backdrop.

Annual Consensus EPS Growth Trends FY21-24

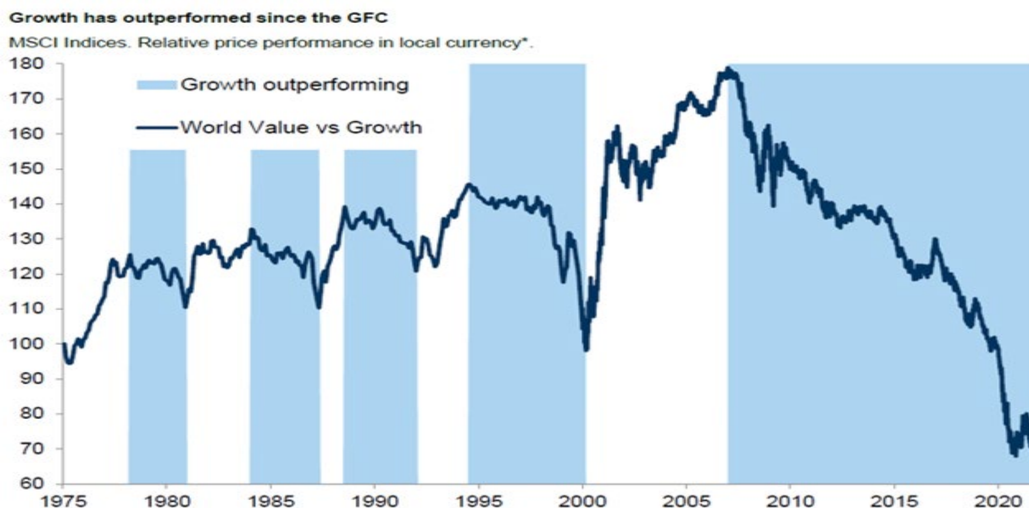


Source: Morgan Stanley Research.

Again, while we would like to believe that fundamentals drive market internals, past experience dictates that the direction of key interest rates and the constant threat of a potential relapse in growth and disruption caused by a fourth wave of the pandemic will dominate the investment debate. **This will culminate in ongoing restless sector and factor rotation**. Central banks have finally fessed up that inflation is higher and more persistent than expected, and that rates need to rise and Quantitative Tapering (QT) needs to occur.

The secular underperformance of Value to Growth since the GFC has been synonymous with low inflation and extremely accommodative monetary policy, negative real and absolute interest rates.

We are now at the major pivot point of "normalisation" and hence growth is no longer a one way bet.



Source: Goldman Sachs.

We believe that the portfolio is well positioned against the above backdrop. Rising interest rates will weigh heavily on the extreme growth at any price and tech heavy names, where we have remained consistently underweight from a portfolio construction and philosophical perspective. It is just a matter of time before the US 10 year bond yields punch through 2%. As we have been saying for a while, we expect inflation to spike. As a result, investors are shifting their focus away from concept stocks and pivoting back to fundamental analysis. Whilst certain stocks in the portfolio are out of favour with the market currently (mostly due to short term earnings pressure caused by supply chain and COVID-19 dislocations), these unloved or mispriced stocks continue to trade at attractive valuations. Alumina and Ansell are good examples of stocks the market clearly seems to hate. Taking a medium term view, they should re-rate over time. It's all about playing the long game, being patient and looking over the valley!

The Beta of the Fund (a measure of volatility) is now 0.85 from 0.92 in December, compared to the market beta of 1.00. This reflects the repositioning of the Fund for higher sustainable dividend growth. The expected FY22 dividend growth rate of investee companies held within the portfolio sits at 18.3% and is comfortably above that of the market at 6.2%. The Fund's forecast dividend yield of 4.5% is higher than the market yield of 4.0%, with the level of franking broadly in line with the market.

Portfolio Characteristics

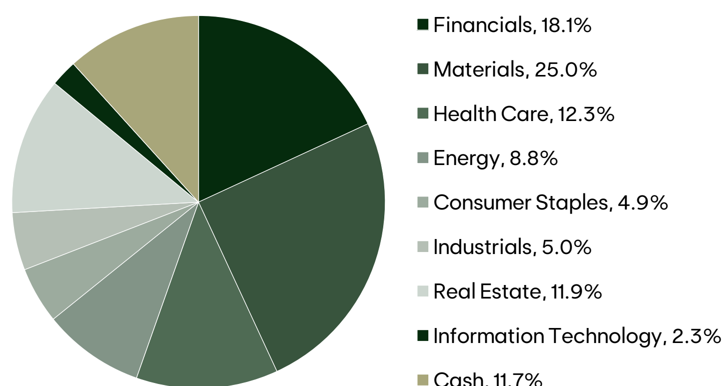
TOP 10 HOLDINGS

BHP Group	10.8%
Ampol	8.8%
NAB	7.0%
CSL	6.4%
Alumina	4.4%
Liberty Financial Group	4.1%
Amcor	3.9%
Ansell	3.6%
GrainCorp	3.5%
Waypoint REIT	3.5%

KEY PORTFOLIO METRICS

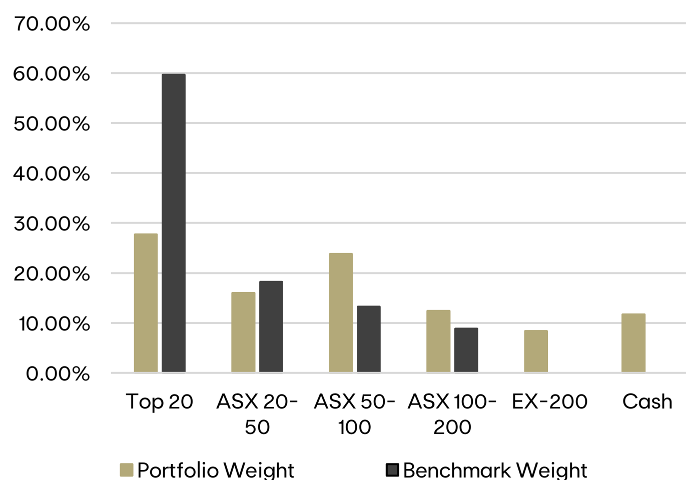
FY22(e)	Fund	Benchmark
Price/Earnings (x)	15.4	17.1
Dividend Yield (%)	4.5	4.0
Dividend Growth Rate (%)	18.3	6.2
Beta	0.85	1.00

SECTOR ALLOCATION



Source: Ellerston Capital.

MARKET CAPITALISATION



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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

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