Ellerston Australian Micro Cap Fund

Monthly Newsletter, January 2022

Investment Objective

To provide investors with long term capital growth by investing in a portfolio of quality Australian & New Zealand Micro Cap companies. The Fund aims to outperform the S&P/ASX Small Ordinaries Accumulation Index over the medium to long term.

Investment Strategy

The Fund employs an active, research-driven investment approach which seeks to identify and invest in companies that are believed to have the potential to deliver significant upside over the medium term and where there is a reasonable margin of safety to mitigate downside risk. Positions are actively managed within the Fund.

Key Information

Strategy Inception ^^	1 May 2017
Portfolio Manager	David Keelan & Alexandra Clarke
Application Price	$1.6021
Net Asset Value	$1.5981
Redemption Price	$1.5941
Liquidity	Daily
No Stocks	53
Management Fee	1.20% p.a.
Performance Fee	20%
Buy/Sell Spread	0.25% on application 0.25% on redemption

Performance Summary

Performance	1 Month	3 Months	6 Months	1 Year	3 Years (p.a.)	Since Inception (p.a.)^^
Net^	-8.09%	-11.20%	-1.80%	10.55%	27.82%	21.92%
Benchmark*	-9.00%	-7.99%	-4.61%	6.65%	10.13%	9.32%
Alpha	0.90%	-3.21%	2.81%	3.90%	17.69%	12.60%

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

COMMENTARY

The Small Ordinaries Accumulation Index had a bumpy start to 2022, falling more than 12% at its peak to finish down 9% for the month. Once again the Small Industrials Index underperformed the Small Resources Index, and value stocks outperformed growth stocks. Looking more broadly, the All Ordinaries were down 6.6% in January which is the fourth worst start to the year since 1960. The global sell off was driven by rising real yields, as the Federal Reserve signalled that it would look to raise rates. With rising bond yields weighing on valuations, the All-Industrials PE de-rated by about 10% to 20x. Against this backdrop, the Ellerston Australian Micro Cap Fund outperformed the Small Ordinaries Accumulation Index by 0.90%.

Given the market volatility, we thought it would be useful to explain how our portfolio performed in context of market sell-off and share some insight into how we construct our portfolio to extract the highest returns with the optimum level of volatility. We construct our portfolio around three key pillars:

- **Prospect position (5-10% of the portfolio)**: small positions which we like but are still getting better acquainted with. The company could be missing a key element such as sufficient capital to fund growth; a material contract win or additional management strength, to name a few examples. We like this approach because it allows us to dip a toe in the water, with the view of building up the position in the name or selling out if our thesis hasn't played within a 12 month period.

- **Core position (50-70% of the portfolio)**: these positions make up the bulk of our portfolio and we invest in companies with a view of holding them for at least a three year period. Typically, this segment would feature high quality businesses, with structural tailwinds, healthy balance sheets and reputable management teams.

- **High Conviction position (20-30% of the portfolio)**: these stocks are core positions which we think are heading into a catalyst rich environment. As such we will upweight these positions in the portfolio to capture additional alpha.

During the most recent market sell off, our portfolio's behaviour was consistent with our expectations. Our "prospect positions" were the most heavily impacted. Generally speaking, these positions are less liquid and have the highest risk/return ratio in our portfolio. As such it is to be expected that these stocks will be most impacted in a violent sell-off. On the contrary our "high conviction" positions were the most stable during the month. While these stocks didn't make absolute returns, they materially outperformed the market during the month.

One of our higher conviction positions Equity Trustees (EQT AU) held steady during January, which is a solid outcome when the market shed 9%. The business is benefiting from several tailwinds, including the ever-growing superannuation pool, along with rising compliance costs and complexity - which is encouraging super funds and fund managers to outsource their trustee and responsible entity functions. This flows through to EQT in the form of strong inflows (where it generates incremental revenue) and ongoing new client wins. The pipeline is solid, and includes both smaller, but rapidly growing funds, and a few whales which will take longer to land. We also think there are M&A opportunities floating around, which would be highly accretive and complimentary, and really help to drive the leverage. Outside of these trends, the company is highly cash generative, with a formidable management team, and we think the reliability of its earnings and growth potential are not fully appreciated at the current valuation.

On the flip side of our higher conviction position in Equity Trustees, one of our spicier core positions Family Zone Cyber Safety (FZO AU) was down over 18% during the month. Being a high growth, but loss-making business FZO was heavily caught up with the tech sell-off, which was exasperated by the fact that it is still relatively illiquid. This aggressive share price move came despite the company releasing a solid 2Q FY2021 result, which saw ARR and a suite of metrics materially ahead of market expectations. FZO announced that it had ARR of $52m with the 2Q FY2021 adjusted for seasonality implying an additional $25m annually. We remain comfortable holders of the name, as it continues to trade at a material discount to its peers and is entering a catalyst rich period.

Looking forward to reporting season we think the market is likely to focus on a number of key factors:

1. **Cost inflation**: Given ongoing issues with supply chains, elevated commodity prices, along with disruptions and tightness in the labour market, we think commentary around costs pressures will be closely watched. The question will be, which costs are transitory and which are now structural.

2. **Earnings outlook commentary/guidance:** While outlook commentary and guidance is always a key focus for the market, we think given the volatility in the market, the companies which provide quantitative outlook will be rewarded.

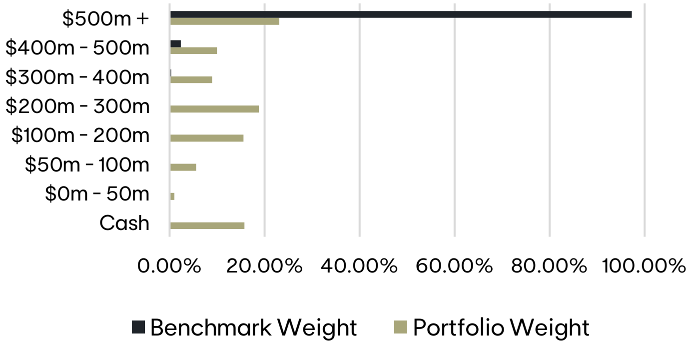
3. **M&A**: Despite current market conditions, balance sheets are reasonably robust and private equity firms have refilled their war chests. As such we believe M&A activity will remain elevated as companies seek out inorganic growth opportunities.

4. **Valuations:** As we have been discussing for some time valuations have been toppy. Consequently, we expect companies which miss earnings expectations will be punished, especially for the stocks trading on large multiples.

While this reporting season will undoubtedly be different to prior years given the macro landscape, we continue to stress-test our positions, and we remain confident our process and portfolio are robust enough to weather the current environment.

PORTFOLIO CHARACTERISTICS

Market Capitalisation



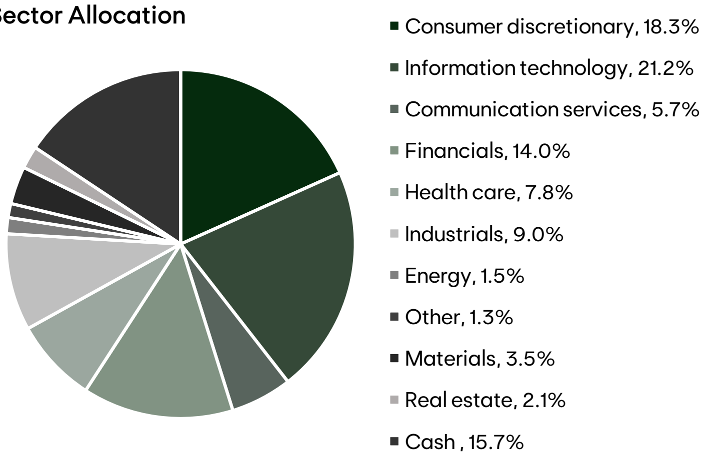
Source: Ellerston Capital.

Key Portfolio Metrics

FY22e	Fund	Benchmark
Price/Earnings	17.1x	18.3x
Dividend Yield	1.7%	3.08%
Net Debt/EBITDA	0.01x	1.06x

Source: Ellerston Capital.

Sector Allocation



Source: Ellerston Capital.

Contact Us

Sydney

Level 11, 179 Elizabeth Street,
Sydney, NSW 2000
+612 9021 7701
info@ellerstoncapital.com

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

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