Ellerston Global Mid Small Cap Fund

Monthly Newsletter, June 2022

Investment Objective

To outperform the MSCI World Mid Cap NR (AUD) Index by 3% over a rolling 5 year period on a net of fees basis, with a focus on risk management and capital preservation.

Investment Strategy

The Funds investment strategy is to construct a concentrated portfolio of global mid small cap securities using the Manager's distinctively contrarian high conviction, benchmark independent investment approach. The Manager believes that the trade-off between risk and potential returns is improved by implementing highest conviction ideas from a filtered universe of securities that are in a period of "price discovery" and offer the best risk/reward.

Key Information

Strategy Inception^^	1 March 2017
Portfolio Manager	Bill Pridham
Class A Application Price	$1.2411
Class A Net Asset Value	$1.2380
Class A Redemption Price	$1.2349
Class B Net Asset Value	$1.0700
Class B Redemption Price	$1.0673
Liquidity	Daily
No Stocks	20 - 40
Management Fee (Class A)	0.75%
Performance Fee	10%**
Buy/Sell Spread	0.25% on application 0.25% on redemption

**10% of the investment return over the benchmark return (MSCI World Mid Cap Index NR (AUD)), after recovering any underperformance in past periods.

Performance Summary

Performance	1 Month	3 Months	1 Year	3 Years (p.a.)	5 Years (p.a.)	Since Inception^^ (p.a.)
Class A^	-8.35%	-11.84%	-19.91%	8.18%	9.50%	9.93%
Benchmark*	-6.10%	-9.31%	-11.63%	5.03%	7.51%	8.15%
Alpha	-2.26%	-2.53%	-8.28%	3.15%	1.99%	1.78%

Performance	1 Month	3 Months	6 Months	1 Year	3 Years (p.a.)	Since Inception*** (p.a.)
Class B^	-8.30%	-11.67%	-26.27%	-19.29%	-	3.93%
Benchmark*	-6.10%	-9.31%	-18.18%	-11.63%	-	6.23%
Alpha	-2.20%	-2.36%	-8.08%	-7.66%	-	-2.29%

^ The net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance.
* MSCI World Mid Cap Index NR (AUD)
***Class B Inception Date is 18 August 2020

ESG in Focus

With Russia's war on Ukraine inflating oil and gas prices all over the world, the spotlight on renewable alternatives has never been brighter. Despite well-known storage and interconnection challenges, technology and scale continues to drive renewable energy costs below traditional coal and gas, and we are seeing massive global buildouts of utility-scale wind and solar capacity.

In particular, solar power is being fast tracked with annual global installations estimated to grow rapidly from 182GW in 2021, to more than doubling to 443GW by 2030. However, the solar industry is notorious for its highly dynamic political and regulatory environment – the so-called "solarcoaster" which constantly threatens its great growth potential.

On this front, President Biden made headlines in early June, using his powers to create a 24-month bridge for the import of tariff-free solar modules and cells from Southeast Asian countries (Malaysia, Thailand and Vietnam) to ensure US has access to a sufficient supply to meet electricity generation needs while domestic manufacturing scales up. By guaranteeing a stable tariff trade environment for the next two years, the US government is making a strong signal of confidence across the entire US solar value chain.

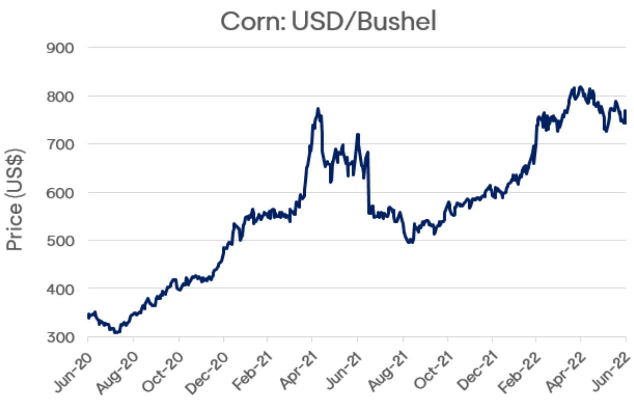
Portfolio Commentary

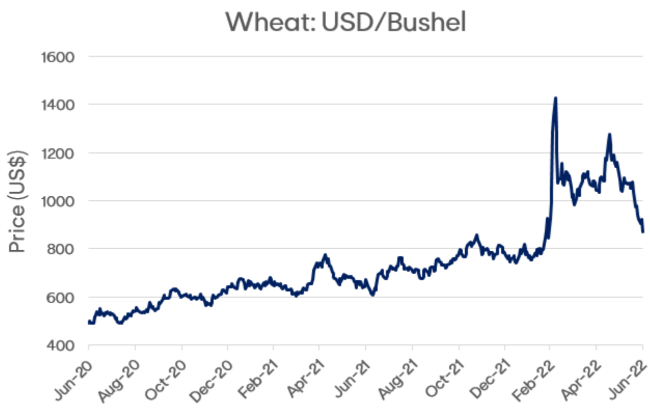
After a very strong FY21 where the Fund appreciated 39.4%, we ended FY22 down by 19.9% which compared unfavourably to the MSCI World Mid Cap (AUD) Index which had an 11.6% drawdown over the same period. While the recent period has been disappointing, we consider our portfolio well suited to generate long term capital growth, underpinned by significant upside to intrinsic value.

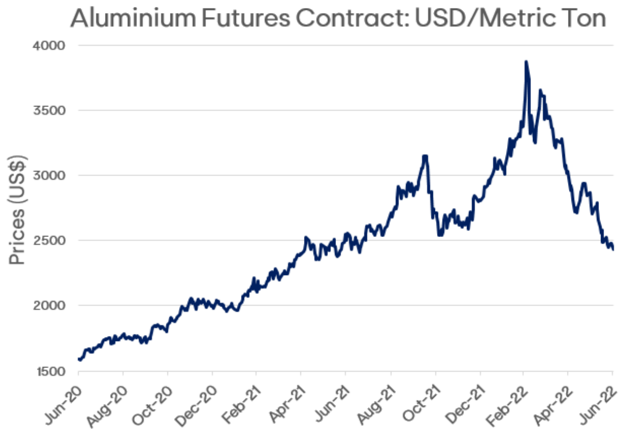
Returns during the financial year ending June 30, 2022, can really be characterized as a tale of two halves. After a relatively solid first six months of the year, the onslaught of negative macro events began to unfold, impacting most asset classes around the globe.

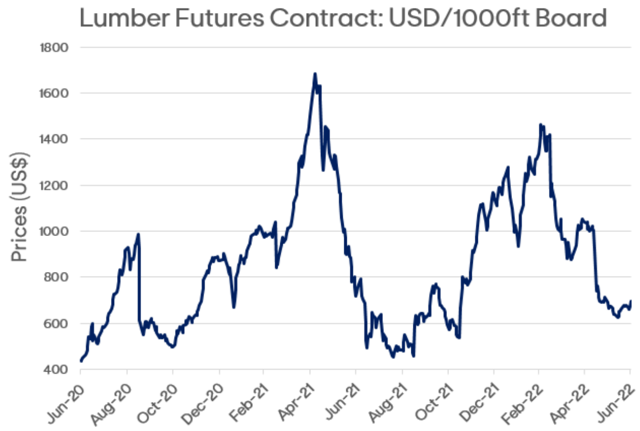
We had the Omicron impact in late December and into January which shut down or hampered many industries globally while inflation, associated with supply chain inefficiencies, continued to mount. In January, Federal Reserve Chairman Jerome Powell basically capitulated on his previously held mantra that inflation would be transitory and signalled a much more aggressive interest rate policy than was previously expected by the market.

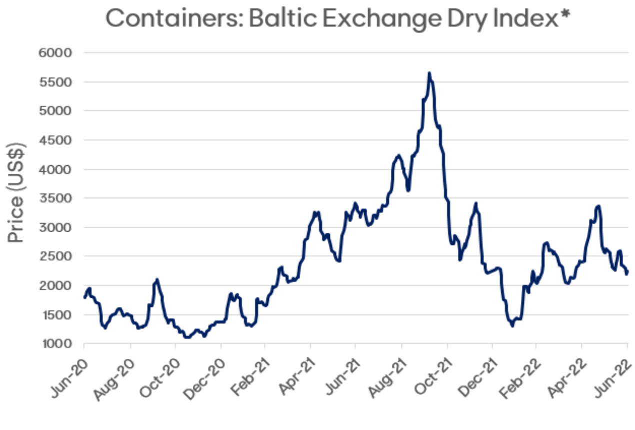
In February, the atrocities in Ukraine really came to the fore as Russia's aggression, both on the battlefield and in the headlines, highlighted Putin's desire to leave a "legacy". What became apparent was the reliance the rest of the world had on Ukraine soft and hard commodities, manufacturing capabilities and in Europe, Russian gas. The limitation of supply coupled with Ukraine shutdowns created a commodity bull market with WTI oil increasing from US$72.17 a barrel in January to almost $120.00 at its peak or >66% within several months. Many other commodities such as aluminium, lumber, corn and wheat skyrocketed as well, creating significant food and fuel inflation for the consumer.

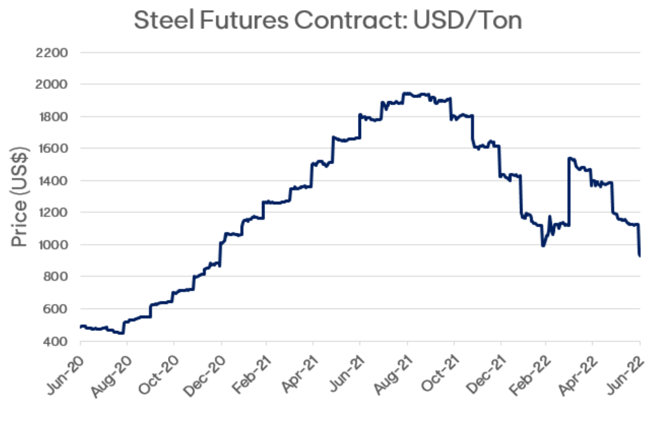












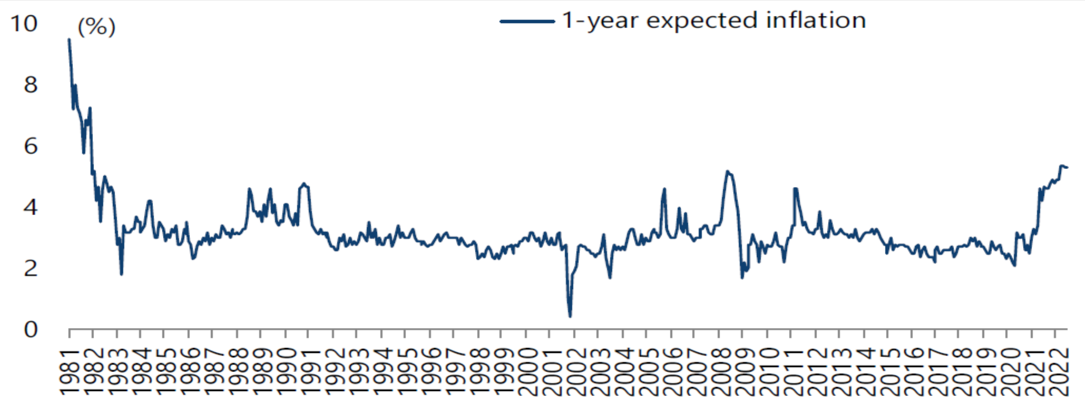
*Source: Bloomberg. *Price index with base level from January 4th, 1985 at 1000 points.*

Given the Fund's focus on investing in industries and companies "that do not harm" our ESG process screens out chemicals, commodities, mining etc. and did not participate in this commodity bull market. The average stock return of the screened industries (which includes the Norges Exclusion List) included in our benchmark from the beginning of January 2022 to the end of June 2022 was -10.4%. While this is not great, it is certainly better than the -26.5% recorded by the remaining stocks – a 1610bps differential.

Not to be outdone by all the negative macro influences, China also threw a spanner the works with its COVID suppression policy escalating in early March. Lockdowns in Shenzhen and Shanghai combined with other rolling lockdowns resulted in an estimated 345m people across 46 cities in full or partial lockdown by April, a population accounting for 40% of GDP. While we have seen some relief with Shanghai opened on June 1st, the pandemic influence has certainly not gone away and still influences demand while complicating the global supply chain.

We consider substantial monetary and fiscal stimulus, which were injected to combat the pandemic economic impact, are the primary sources of our inflation problem. Central Banks (outside of China) are now raising rates and reducing liquidity to combat inflation as real-world inflation expectations have broken out of a long-term trend in the past several months. The key push by authorities is to dampen the risk of wage price spirals becoming out of control and as such are focused on dampening economic activity and subsequently the labour market which would, in theory, bring inflation expectations back to long term averages.

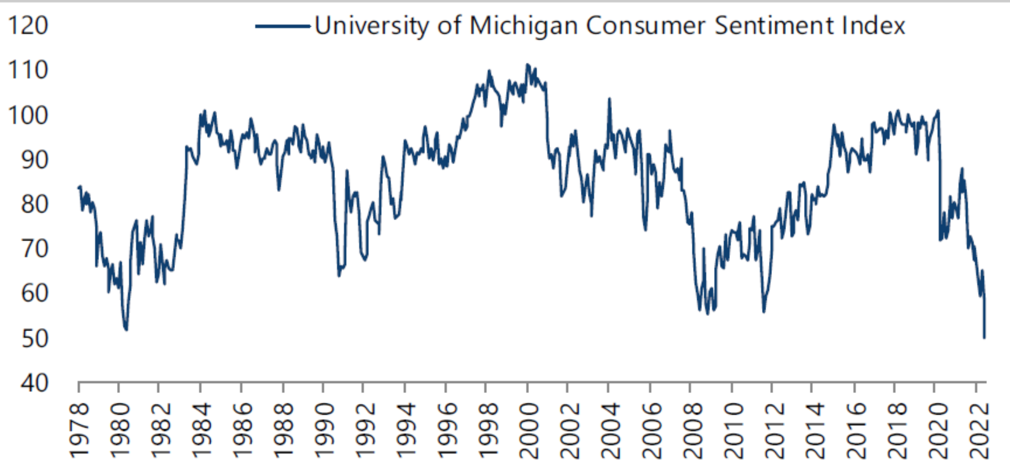
University of Michigan consumer survey: One-year median expected inflation



Source: University of Michigan

While March and April were encumbered by all the same previously discussed macro variables, in May and June the narrative switched from just inflation to mounting recession risks on the back of demand destruction. This was the result of stubbornly high inflation prints, rising mortgage rates and a significant increase in petrol prices at the pump weighed on consumer sentiment readings currently at generational lows. Retail sales have flattened out in the US and Europe, and while part of the softening is likely attributable to the shift from goods to services, consumer confidence and associated demand destruction from surging inflation is also a key driver.

University of Michigan Consumer Sentiment Index



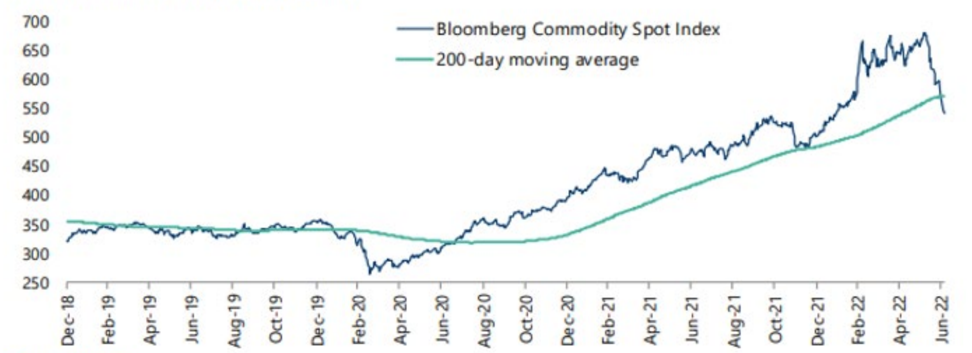
Source: University of Michigan

Looking Ahead

OK, so none of the information we have provided here is new or particularly insightful. It reflects rear view mirror data points that are important to take into account in our investment process and positioning decisions as they show where the path might lead. The interesting aspect of the incessant recession risk commentary is that it is becoming a self-fulfilling prophecy – not in a recession itself (yet), but price movements in anticipation of such.

We discussed the boom in commodities over the past several months, have a look at the Bloomberg Commodity Spot Index now as the narrative shift from inflation to recession has resulted in demand destruction concerns. Lumber, aluminium, steel and soft commodities are well off recent highs and if these are inputs into your company end product and the demand around your products is relatively intact, we could see some idiosyncratic examples of strong margin improvements from companies that have been pricing to offset these costs.

Exhibit 1: Bloomberg Commodity Spot Index



Source: Bloomberg

Supply chains around the world are being scrutinized as countries and corporates look to protect against future misalignment between supply and demand, i.e. can we get the product manufactured, who is providing the raw material and labour inputs, can we get it shipped to where it is needed and at what cost? Even more importantly, the focus on energy security has become more intense as Europe's reliance on Russian gas is now untenable.

In this environment of heightened macro risks, it is important to focus on investing in high quality companies with strong balance sheets and cash flows with an attractive valuation underpinned by decent earnings visibility. We are looking to have exposure to secular or structural growth opportunities which will drive long term earnings, high or growing market shares in large addressable markets, high customer retention rates and recurring revenues as well as pricing power. Additionally, we like to invest in companies that are doing good, in respect to our environment or socially – these businesses typically have innovative products which are increasingly in demand while higher priced virgin raw materials can be replaced with lower cost recyclable products which will augment margins.

Lets discuss a few of these now:

Assurant is a global leader operating under a business to business to consumer model partnering with some of the world's largest consumer brands offering protection and integrated services across mobile devices, automobiles, and homes. It has operations in 21 countries which highlights its global mindset and market opportunity with very long-term partnerships underpinned by its high customer retention rates. Approximately 80% of its earnings are fee-based and capital light with market leadership positions providing significant scale advantages for its specialised solutions. We have Assurant trading on <11x PE with over half a billion of excess capital on its balance sheet.

Cellnex is the largest independent owner of mobile tower assets in Europe controlling over 20% of all towers in the region. Structural drivers include 5G densification and telco outsourcing. These assets are very difficult to replicate from a cost and permitting perspective, have long term contracts linked to inflation with the majority of its debt fixed at very attractive rates. We have owned Cellnex for over 4 years and have never seen the business trade as cheap as it is today, likely due to its 100% European exposure and uncertainty around a potential deal to acquire Deutsche Telekom Towers, which will be resolved shortly. Management recently confirmed FY25 EBITDA of €3.4bn with subsequent recurring free cash flow of €2.1bn placing it on a high single digit yield. The business has incredibly high earnings certainty and would represent a great pension asset.

Willscot Mobile Mini has over 45% market share of all modular office leasing units in North America with significant economies of scale benefits as a result. It has almost 3yr average leasing terms with current pricing about 30% higher than what is in the field today. Therefore, when these units get returned, they are redeployed at the much higher spot rates with minimal capital spend. The cost to replace its assets has gone up materially and by our calculations it is currently trading below replacement cost while underpinned by substantial pricing power as the cost of its units are only half to one percent of the total project cost. As a result, it has strong earnings visibility and a good line of sight to over $1bn EBITDA and significant cash flow. The business is currently trading on about 10.0x EBITDA and 7.5% free cash flow yield.

Graphic Packaging is the world's largest folding carton manufacturer with significant market share providing strong economies of scale benefits. It is innovating new products to replace plastic in our consumption stream with paper-based packaging and this is providing a new source of growth. Given its market share, it is able to pass through all commodity cost inflation, albeit with a time lag. This year should see a $200-400m benefit as it catches up on last year's commodity increases and given its end markets are predominately very durable consumer staples, it should have quite high earnings visibility going forward. With price increases, organic growth, efficiencies from new plants and recent acquisitions, it should grow earnings at a double-digit rate over the coming years while generating over $700m of free cash flow next year. We have the business trading on less than 9.0x PE.

Option Care Health is the largest independent provider of at home infusion services in the US (reaching 96% of the US population) and recently delivered a very strong start to FY22 despite continued impacts on labour availability associated with COVID. It continues to benefit from the shift of infusion services from the hospital setting to the more convenient and significantly less costly at home setting. Management indicated it will accelerate its M&A strategy as its balance sheet is in great shape and the business is generating accelerating free cash flow. Additionally, it will increase the number of infusion suites available (stop in on your way home) which will help with labour efficiency. Recently upgraded FY22 EBITDA guidance of $328m midpoint looks conservative with further upside from accretive M&A likely through the year.

Webster Financial has recently completed its merger with Sterling Bank which will result in a regional bank powerhouse in Northeast US – think the Boston and New York regions. It will benefit from an expanded balance sheet which enables greater access to larger loan originations (at very little incremental cost) and as one of the larger HSA Banks in the US it will have significant cross revenue opportunities going forward. In its last earnings call, Management was confident on delivering 8-10% loan growth over the next couple of years and this will come at expanding net interest margins as rates ratchet up over the coming months. As a combined group, WBS is trading <7.0x PE with a 4.4% dividend yield while generating about $400m of excess capital per year which will be returned to shareholders or reinvested to drive further growth.

Sensata is a global leader in mission critical sensors which are primarily used in the automotive, heavy vehicle and industrial markets. The business benefits from increased sensor content per unit as safety requirements/regulations expand and clean energy applications increase over time. Typically, it outgrows its end markets by 4-6% which basically means even if its end markets are flat, it will still grow mid-single digit. Management recently held an Electrification Teach in webcast in which it highlighted sensor content per vehicle more than doubling as we move from internal combustion engines to electric. Consequently, it sees a $15bn addressable market by 2030 and expects electrification revenue to grow at a 50% compound rate and come in around $2bn by 2026. To put this in context, we expect Sensata to generate just over $4bn of revenue in 2022 so the opportunity is very material to revenue and earnings growth over the next several years. Sensata is trading on a forward PE of 9.5x PE while generating over half a billion of free cash flow.

Chart Industries is a global leader in providing technology, equipment and services serving multiple market applications in Industrial Gas and Energy. Chart's technology and products are found in hydrogen, biogas, carbon capture, food and beverage as well as water treatment applications to name a few. It has been involved in hydrogen markets for decades and currently holds dominant market share in North America (60%) and Europe (40%). Over the past several months it has been raising prices to offset commodity input inflation, primarily aluminium, stainless steel and carbon steel. Now that the cost of these inputs has become less onerous, we believe the set up for margins could be quite interesting given that it will likely retain the majority of recent price increases as demand for its products remains robust. It is a key beneficiary of the need for alternative solutions (hydrogen) for energy security and its associated backlog continues to build as a result.

TKH Group is a leader in 2D and 3D machine vision and security vision systems, number one player in next generation tyre manufacturing systems and a leader in providing medium voltage energy cables to the renewable energy sector. It is participating in a number of global megatrends and is finetuning its portfolio to provide investors with a pure look through to these opportunities. It aims to grow revenues to >€2bn with margins approaching 17% by 2025 as it focuses on its high value add capabilities. TKH reported its full year results on March 8th and delivered an impressive 15.9% organic sales growth while EBITDA grew 32.5%. Management remains confident in delivering on its strong order book and participating in the secular drivers of its end markets with further growth expected in FY22. TKH is trading on a forward PE of 9.7x and just over 6.0x EBITDA.

Summary

We have just covered almost 40% of the Fund with these names and we hope the takeaway is that they operate in large addressable markets, have strong market positions, great balance sheets and cash flows while trading on attractive multiples. The future is influenced by a number of factors and so much randomness that it is impossible to predict future events with any consistency. Absolutely nobody had a pandemic on their radar screen and this became a defining event in our lives – this just shows that we don't know what is going to happen and as such, a balanced, conservative investment approach is incredibly important.

While there are an incredible number of moving parts influencing the market right now, the constant is our focus on our businesses, understanding the risks and opportunities and weighting these accordingly.

We thank you for your continued support and look forward to sharing updates over the coming months.

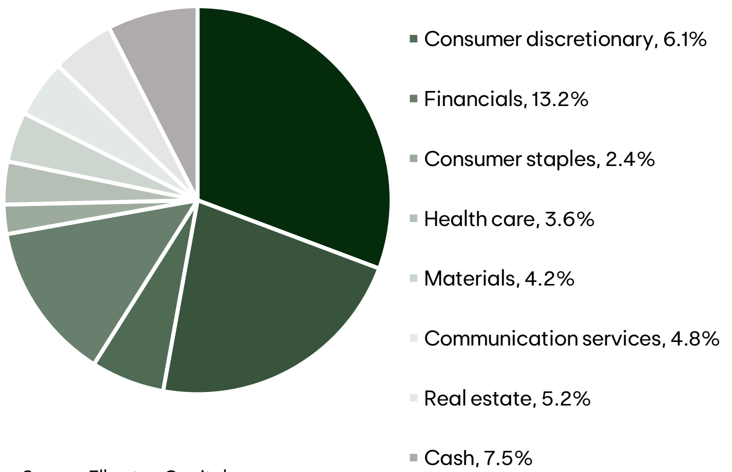
Portfolio Characteristics

Holdings

Top 10 holdings	Country	Sector	%
Assurant	United States	Financials	5.38%
WillScot Mobile Mini	United States	Industrials	4.96%
Cellnex Telecom	Spain	Communication Services	4.82%
Sensata Technologies	United States	Industrials	4.48%
Graphic Packaging	United States	Materials	4.17%
Flex Ltd	United States	Information Technology	4.08%
PTC Inc	United States	Information Technology	4.08%
GXO Logistics	United States	Industrials	3.59%
Option Care Health	United States	Health Care	3.58%
Webster Financial	United States	Financials	3.55%

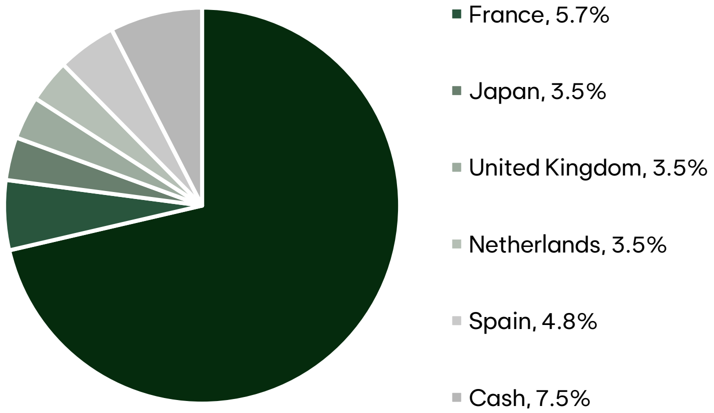
Source: Ellerston Capital.

Sector Allocation



Source: Ellerston Capital.

Geographic Allocation



Source: Ellerston Capital.

Regulatory Guide (RG240) Fund Disclosure Benchmark – Periodic Reporting (monthly)

- **Net Asset Value of the Fund and Redemption Price of Units**
  Please refer to details on page one.

- **Any changes to key service providers including any change in related party status**
  There have been no changes to key service providers, including any change in related party status.

- **Net returns after fees, costs and relevant taxes**
  Please refer to details on page one.

- **Any material changes to the Fund's risk profile and strategy**
  There have been no changes to the Fund's risk profile and strategy.

- **Any material changes related to the primary investment personnel responsible for managing the Fund**
  Please refer to details on page one; there have been no changes to the primary investment personnel responsible for managing the Fund.

Contact Us

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, Mainstream Fund Services on **02 8259 8550** or **InvestorServices@MainstreamGroup.com**

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