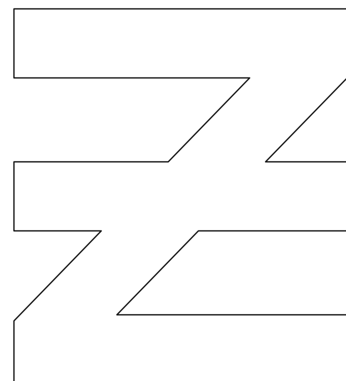


Ellerston Global Equity Managers Fund (GEMS)

Class A and B

Monthly Newsletter, June 2022

Investment Objective

The investment objective is 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 January 2002
Portfolio Manager	Ashok Jacob & Arik Star
Class A Redemption Price	$1.4485
Class B Redemption Price	$1.4175
Gross Exposure	168.59%
Net Exposure	33.03%
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*	1 Year	2 Years (p.a.)	5 Years (p.a.)	10 Years (p.a.)	Since Inception (p.a.)^^
GEMS A	-13.5%	17.1%	11.3%	13.4%	12.6%
GEMS B	-13.4%	17.2%	11.3%	13.2%	12.4%

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

A Historic Opportunity Awaits

During periods of equity market distress and contraction, investment opportunities with the most compelling risk/reward skews present themselves, as do opportunities to potentially own some of the best business franchises, that always seem too expensive, at a reasonable valuation. History indicates that the next twelve months is going to be a generational opportunity to build a portfolio for the next 5 years. When we look back at the 12 times since 1957 when the S&P500 has corrected more than 20%, on 10 of those occasions the market has been higher one year later and significantly higher three years later. Only on one occasion has the market been down (-5%) after three years. This is neither a time to drown in bearishness nor live in hope that yesterday's bull market will be back tomorrow.

Investors are being burnt, and millennials fried to a crisp. If this market stays down at these levels and hope turns to despair, there will be further significant capitulation from retail investors globally. We are just coming back to normality as far as markets are concerned, driven by earnings multiples as opposed to revenue multiples. The reality is that where markets have come from was abnormal and we won't be seeing that AGAIN for a long time. The only investors that will survive and prosper are those that accept that.

The current macro hurricane driving markets will moderate in time. But we want to stay largely on the side lines until we feel that there is improved visibility. This could come from insights attained from earnings seasons ahead of us, and where the US Federal Reserve (Fed) lands in terms of balancing between inflation and recession. Which side of that line the Fed lands will be very important in terms of portfolio positioning. As such, we have materially reduced the GEMS portfolio gross and net exposures, market beta and exposure to earnings risk. We are focused on identifying the opportunities that are emerging from this downturn that will generate outsized returns with outstanding risk/reward skews.

PERFORMANCE

For the 3 Year period from June 30, 2019 to June 30 2022 the Compound annual return for the Australian S&P/ASX 200 Total Return Index was +3.3%, the US S&P 500 Index was +10.6%, the Russell 2000 Index was +4.2% and MSCI World (Local) Index was +7.9%. **Your Fund (GEMS A) net after fees returned +18.0%.**

For FY2022 from June 30, 2021 to June 30, 2022, the Australian S&P/ASX 200 Total Return Index was down -6.5%, the US S&P 500 Index was down -10.6%, the Russell 2000 Index was down -25.2% and MSCI World (Local) Index was down -11.1%. Your Fund (GEMS A) was down net after fees -13.5%.

Calendar Year to Date from January 1, 2022 to June 30, 2022, the Australian S&P/ASX Total Return 200 Index is down -9.9%, the US S&P 500 Index is down -20.0%, the Russell 2000 Index is down -23.4% and MSCI World (Local) Index is down -18.3%. Your Fund (GEMS A) is down net after fees -13.5%.

For the Month of June 2022, the Australian S&P/ASX 200 Total Return Index was down -8.8%, the US S&P 500 Index was down -8.3%, the Russell 2000 Index was down -8.2% and the MSCI World (Local) Index was down -7.8%. Your Fund (GEMS A) was down net after fees -8.8%.

Note: The performance for all Indices is total return inclusive of dividends.

Portfolio Performance:

As we have articulated previously, we look at performance with a longer term multi-year lens as opposed to a shorter term weekly or monthly lens. In this context the GEMS Fund has generated the following net returns after fees for the period ending 30 June, 2022, since inception (20 years) +14% compound annually, 3 years (including the COVID period) +18% compound annually, and the just completed Fiscal Year 2022 -14%. Your GEMS portfolio had a very difficult month to close out the 2022 Financial Year, declining –8.8%.

At the end of June 2022, the Nasdaq (NDX) was at the same level it was at in November 2020, and the S&P 500 (SPX) at the same level as February 2021. The upward spikes will look like a blip in history, but too many investors bake their expectations off the abnormal COVID highs, where growth rates combined with revenue multiples drove valuation justifications. Your GEMS Fund has carried significant exposure to both the NDX and SPX. Over the period of time where the NDX and SPX have done a round trip post COVID to be flat, the GEMS gross returns, including decrement due to hedging, have been +44.0% and +2.6% respectively.

While FY21 was a tale of multiple double digit up months, FY22 year was negatively impacted by two bad months. We are very disappointed with our performance for the past Fiscal Year, particularly May and June, where we read the economic tea leaves incorrectly and carried too much beta during a very uncertain time.

The actions of the Fed, discussed below, were a primary cause of global equity markets plummeting in June, with the S&P500 sustaining its worst calendar year first half performance in 50 years. This was also combined with rumblings that demand destruction was already happening. There was nowhere to hide and we had clearly well overstayed our welcome as some of our holdings sustained a 20-25% drawdowns. Bizarrely a material part of the portfolio decrement in May/June 2022 was due to the same investments that provided great performance during FY21 and most of FY22. Primarily cyclicals.

Let's look at an example of this – Alcoa.

Having peaked at north of $3,800/tonne in March 2022, the Aluminium spot price had fallen to $2,445/tonne at 30 June, 2022. Based on an average realised price of $2,580/tonne the company is forecast to generate circa $3.4 billion of EBITDA this year. We met with the company in the US in May and they were confident and constructive about the future, indicating that production was sold out.

Now, let's assume that management has been hopelessly blindsided and demand has been crushed and will remain crushed. If that proves to be the case, we are looking at a prolonged, deep recession, and the markets will likely be down 10% - 25% from here. Aluminium is an extraordinarily sensitive metal to economic output. In that scenario, if we assume that EBITDA falls 60% to $1.36 billion and the stock trades on a multiple of 5.5x, Alcoa, with net cash on its balance sheet, will be churning out Free Cash Flow of circa $400 million on a circa $7.5 billion Market Capitalisation.

Where is the long term downside in this stock in an ESG environment, with minimal capacity coming online anywhere and ongoing curtailment of production in Europe due to gas prices?

Market Commentary

What we are seeing at the moment is the bursting of a gigantic bubble, one of the largest the world has ever seen. However, this bursting process is far from complete.

We are surrounded by investors who have only been through the last cycle and are thumping the table about stocks that are down north of 70% but still trading on revenue multiples north of 7x and/or EBITDA multiples north of 50x, if there is in fact any EBITDA. The market is in the process of transitioning from revenue multiples to earnings multiples and is still not there.

The 2021 acquisition vintage may well be the worst in 100 years. An example of how this unfolds is the cohort that bought Microsoft in late 1999, towards the peak of the tech boom. Over the following twelve years, although the company compounded earnings at 20%, the stock fell 75% and took seventeen years to reach its previous high. That was for a great company with dominant franchise and market positioning. Investors had paid the wrong price.

While equity prices have slumped, we expect there is still a significant earnings downgrade cycle ahead of us. Any company exposed to the consumer anywhere in the world is in the eye of the storm and likely to downgrade earnings, as are B2B companies as business confidence deteriorates. Equity markets, as Warren Buffet said, are relentless discounting mechanisms and these downgrades are possibly priced in some cases, but the quanta are different from company to company.

Macro Commentary

As we stand today, we believe the Fed will drive the economy into recession. We are currently seeing signs of this everywhere. The bigger question is the depth and longevity of this recession, as well as the government and Fed policy responses.

Looking out over the next 12 months, we can't help but wonder if the key word is "Peak". Peak Inflation! Peak Consumer! Peak Labour Market! Peak ESG! Peak Confusion! We wonder could we be at or close to any or all of these. We also see some elephants in the room, including the oil price, Japan's ongoing monetary experiment, and the Russia construct.

Let's tackle inflation. Although there is a very real possibility that inflation has peaked for now, we continue to believe that inflation is not merely transitory and will at least remain elevated for a long period of time. History tells us that inflation is stubborn, not readily controllable, and near impossible to quickly put back in its bottle. Extreme levels of stimulus during 2020 and 2021, coupled with now in retrospect excessive government spending, materially contributed to a gap between demand and supply. This has been the root cause of the high inflation we are currently experiencing.

The Fed, aka Jay Powell, was perfectly happy with this state of play until the data was too hot to ignore, leading the Fed to make a 180 degree turn and declare war on inflation, going from a policy mistake to a policy blunder.

At the May 4th post Fed meeting press conference Chairman, Jay Powell reminded us all that the Fed has two mandates, *"to promote maximum employment and stable prices for the American people"*. He highlighted the Fed's decision to increase the fed funds rate by 50 basis point and to *"significantly"* reduce the size of its balance sheet over time. Having articulated that *"The labour market is extremely tight, and inflation is much too high"*, there was an increased concern about inflation persisting. However the Fed remained very measured and calm outlining that *"there is a broad sense on the Committee that additional 50-basis-point increases should be on the table at the next couple of meetings"* and *"a 75-basis-point increase is not something the Committee is actively considering".*

Then came the piece of data that materially upped the ante and sent the Fed to the next level of whatever it takes hawkishness. On June 10th, The Bureau of Labor Statistics' May Consumer Price Index (CPI) showed a year-over-year increase of 8.6% in May (highest level since 1981), up from 8.3% in April. Economists were expecting an 8.3% increase in May. Hot data indeed!

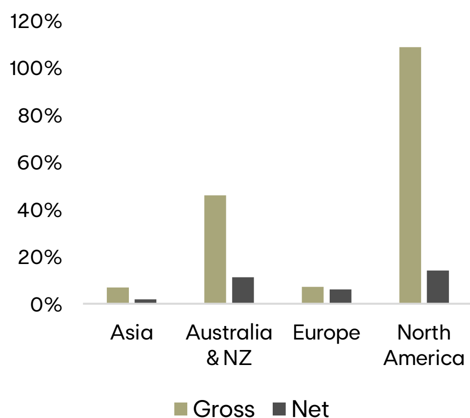
At the June 15th Fed meeting the fed fund rate was increased by 75 basis points. At the post Fed meeting press conference Jay Powell commented that *"Aggregate demand is strong, supply constraints have been larger and longer lasting than anticipated, and price pressures have spread to a broad range of goods and services", "participants continue to see risks to inflation as weighted to the upside", "Inflation has again surprised to the upside, some indicators of inflation expectations have risen, and projections for inflation this year have been revised up notably"*, and *"So what we want to see is a series of declining monthly readings for inflation, and we'd like to see inflation headed down. Frankly we saw last year, inflation came down over the course of the summer and then turned right around and went back up. So, I think we're going to be careful about declaring victory."*

The Fed had clearly telegraphed that to bring inflation back to its 2% target rate it needs to and is prepared to crush demand and drive the economy into a recession. To enable the achievement of this it increased the velocity of interest rate increases, and Jay Powell clearly stated that he wanted to see a *"series"* of data points for declining inflation before changing course.

The ghost of Arthur Burns, who led the Fed during the critical inflationary years of the 1970's looms large. His transitory view led to the Fed being way behind the curve and a series of policy blunders. He was also bullied by President Nixon to in fact cut rates, which he did at one point. The Burns and Powell eras have a distinct rhyme at this juncture. Some say that Powell's Fed is further behind the curve than Burns' Fed ever was. Although any economic contractions are immaterial compared to the GFC in the sense that no part of the financial infrastructure is broken, the difference this time is we may need to pass through an elongated slow down to pass through inflation. In the meantime, the grand experiment of quantitative easing, zero interest rate policy and now rate normalization and quantitative tightening continues.

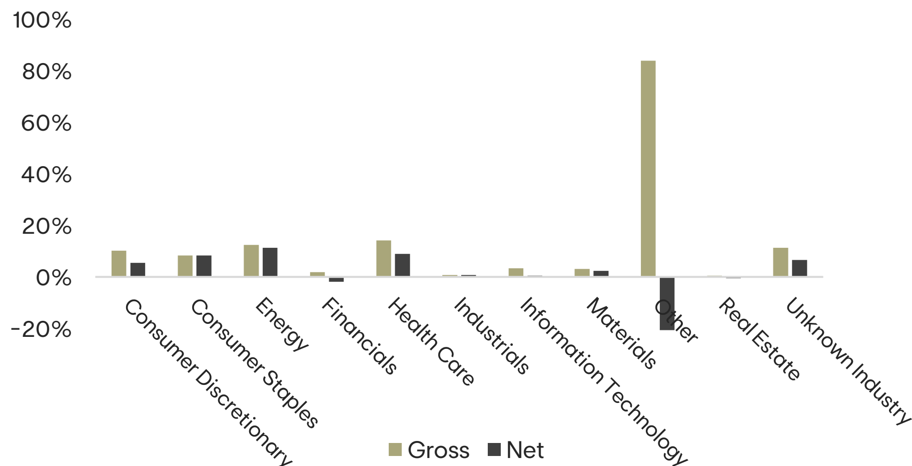
PORTFOLIO CHARACTERISTICS

Region Exposure



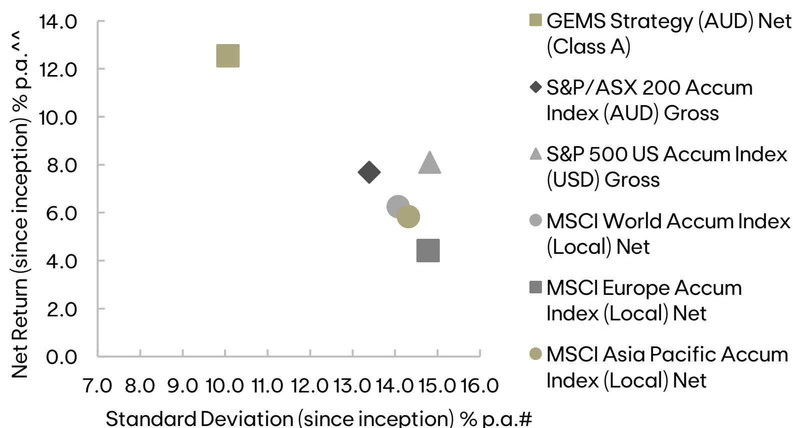
Source: Ellerston Capital.

Sector Exposure



Source: Ellerston Capital.

GEMS Strategy Performance & Volatility^



Source: Ellerston Capital.
Past performance is not a reliable indication of future performance.

Top 10 Holdings (Alphabetical, Long Only)

- ANIMOCA BRANDS
- BOOKING HOLDINGS
- CELSIUS HOLDINGS
- CIENA CORP
- GENERATION DEVELOPMENT GROUP
- GOLAR
- GRAINCORP
- LIGHT AND WONDER
- RALPH LAUREN
- YELLOW CAKE

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

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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 holdings 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.

^^For the period 1 January 2002 to 30 April 2006, the CPH Group GEMS Portfolio was not operated within a separate fund structure. The underlying investment assets of the CPH Group GEMS Portfolio were owned during that time within corporate entities of the CPH Group for which audited accounts were prepared on an annual basis. Accordingly, in order to provide relevant historical performance information for the period 1 January 2002 to 30 April 2006 (Historical Returns) net returns were calculated on the basis of the actual dollar returns of the CPH Group GEMS Portfolio adjusted to reflect a fund structure similar to the Fund and including all fees. For GEMS B, GEMS A returns have been used between 1 May 2006 and 2 November 2009. The returns of the Fund and the relevant Indices are net of fees, expenses and taxes and assuming distributions are reinvested.

The standard deviation is often used by investors to measure the risk of an asset. The standard deviation is a measure of volatility: the more an asset's returns vary from the average return, the more volatile the asset. A higher standard deviation means a greater potential for deviation of return from the average return of the asset.

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