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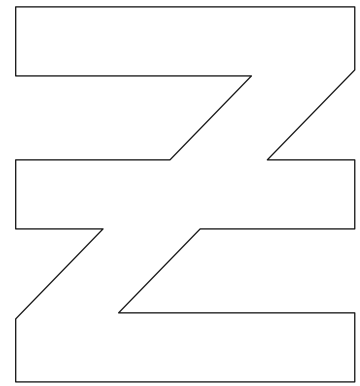


Ellerston Equity Income KIS Fund

Monthly Newsletter, October 2022

Investment Objective

The investment objective of the Ellerston Equity Income KIS Fund ("KIS" or "the Fund") is to provide investors with returns and income growth greater than the S&P/ASX 200 Accumulation Index over rolling 5 year periods.

Investment Strategy

The Fund is a fundamental, bottom up, concentrated Australian equities strategy with a clear focus on delivering sustainable dividend income for investors through an actively managed portfolio of stocks throughout the market cycle.

Key Information

Strategy Inception^^	1 May 2019
Portfolio Manager	Chris Kourtis
Application Price	$1.0027
Net Asset Value	$1.0002
Redemption Price	$0.9977
Liquidity	Daily
No Stocks	31
Strategy FUM	$21.7m
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	Quarterly

PERFORMANCE SUMMARY

Performance	1 Month	FYTD	1 Year	2 Years (p.a.)	3 Years (p.a.)	Since Inception (p.a.)^^
Net^	4.56%	2.81%	-0.04%	11.91%	7.21%	8.29%
Benchmark*	6.04%	6.45%	-2.01%	11.98%	4.82%	6.32%
Alpha	-1.49%	-3.65%	1.97%	-0.07%	2.39%	1.98%

^ 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.

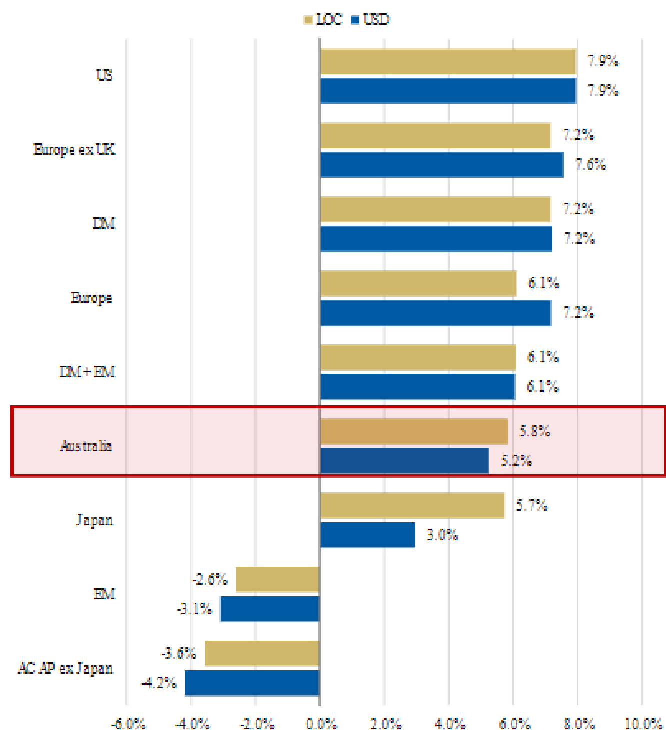
MARKET OVERVIEW

Equities had a strong month in October on the expectation that central banks are nearing the peak of policy tightening, lifting investor sentiment across global share markets. The MSCI Developed Markets Index rose (+7.1%) and the S&P 500 gained (+8.1%) in local currency terms.

Energy, Industrials and Financials were relative outperformers, with Developed Markets outperforming the Emerging Markets.

Locally, the S&P/ASX 200 underperformed the DM World, but still moved up (+6.0%) in October, as investors responded to a more dovish than expected RBA 25bps hike.

MSCI Global Country/Regional Indices in October 2022



Source: Morgan Stanley.

USA

Economic indicators continued to soften in October, but inflation and employment data remained elevated. September nonfarm payrolls climbed by 263k, a deceleration from the 315k in August and the unemployment rate fell 0.2% back to 3.5%. The September core CPI at +0.6% MoM (+6.6% YoY) was worse than expected and also the core PCE price index - the Fed's preferred inflation measure - rose from 4.9% to +5.2% YoY. It raised the odds of a 75bps hike, which ensued at the November FOMC meeting, where the Fed Fund Rate was lifted by 75bps to 3.75% - 4.0%.

The Dow Jones Industrial Average closed up a whopping 14.1%, the S&P 500 finished 8.1% higher, with the NASDAQ Composite Index the laggard, posting a 3.9% rise as a number of big tech names continued to sell off.

Europe

The Euro-zone economy is clearly headed for a recession based on the October PMI data which were flashing red. The composite gauge slumped more than expected to 47.1, its lowest since April 2013 (excluding COVID lockdown months). The steepest downturn came in manufacturing (46.6, down from 48.4 and below cons 47.9), especially energy-intensive sectors. Services fared slightly better printing at 48.2, but likewise in contractionary territory. Germany was particularly weak, its Composite PMI printed at a low 44.1, down from 45.7 in September.

The ECB raised rates another 75bps against the backdrop of September's 9.9% annual inflation rate (up from 9.1%), but lower than the October posted number at 10.7%, an all-time high and a long way from the ECB's 2% inflation target.

In the UK, Prime Minister Liz Truss suddenly resigned after just 44 days in office, citing an inability to fulfil the mandate upon which she was elected. Her unpalatable policies simply thrust her into the political wilderness. Conservative leadership contests typically take a couple of months to play out, however, given the fragile situation in bond and currency markets and the low appetite for another bruising contest, the party announced that Boris Johnson's ex-chancellor Rishi Sunak, had led the Conservative party race and ultimately was announced as the next British prime minister. Ridiculous state of affairs!

The Euro STOXX50 Index finished the month up 9.1%. Among the major exchanges, Germany's DAX rose 9.4%, France's CAC 40 was 8.8% higher and UK's FTSE 100 ended up 3.0% higher.

Asia

The 20th Communist Party Congress drove markets in Hong Kong and China, with Xi Jinping securing the leadership for his third session. This should have been of no surprise and had been prepared since the announcement of the removal of time limits on the position of head of state (often called the presidency) in 2018. Similarly, the pivot by Congress from development to security was also well known and anticipated. The real surprise was the brutal aftermath post Congress and sharp sell-off in Sino tech names. The Hang Seng closed down 6.4% on the day (biggest drawdown since 2008), with HSTECH -9.6% and the CSI 300 fell 2.9%. The selling predominantly focused on tech names (Alibaba -11.4%, JD -13.1%, Meituan -14.8%). There have only been 6 worse days in H-Shares history. The Yuan weakened to 7.3 against the US dollar, an all-time low since its inception in 2010.

Asian equity markets were mixed, with the Korean KOSPI and the Nikkei 225 both up 6.4%, followed by India's SENSEX 5.9% higher. In contrast, the China SSE finished 6.2% lower in the wash up and the Hang Seng was the standout laggard, down 14.7%.

Commodities

Commodity prices were weaker across the board, as demand destruction and China COVID lockdown concerns weighed on sentiment. Iron ore was the major casualty, with the price down 17% to US$79.50/tonne on the back of weak Chinese demand, due to the softening property market, cautious consumer and ongoing lockdowns. The Brent oil price bounced back 8% to US$95/barrel post OPEC+ announcing a 2 million barrel a day (2% of global supply) cut to oil output. This countered Biden's oil releases from the Strategic Petroleum Reserve in an attempt to keep prices down. Natural gas prices tanked in Asia and were particularly weak in Europe as its gas storage ramped back up to 99% of capacity. The European TTF spot gas price dropped a staggering 48% to US$24/MMBtu and the JKM spot LNG price ended 29% lower at US$28/MMBtu. This price action also dragged thermal coal prices down 13% to US$356/tonne. The base metals complex was mixed, with the major metals; aluminium and nickel both up 4%, and copper down 2%. Gold eased 2% to US$1633/ounce as US bond yields edged higher.

Bonds

US bond yields continued their upward trend, as the US 10-years sold-off by a further 25bps to 4.05%. Soft patches in recent economic data contributed to market participants contemplating once again the potential for the Fed to be closer to the end of their aggressive tightening cycle. The Australian 10-year bond yield fell 13bps to 3.76%, given the more dovish than expected RBA 25bps hike.

Australia

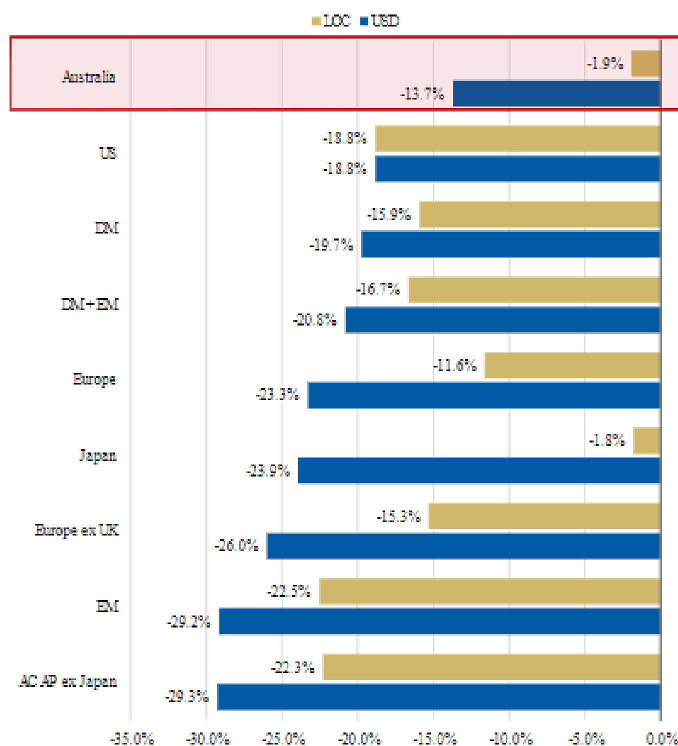
The RBA laid to rest the final hopes of the 50bp advocates on Cup day, delivering another 25bp interest rate increase (the 7th in a row) to 2.85%, despite also revising higher their inflation forecasts from 2022 to 2024. The read through for the market was that if the current inflation scenario didn't stir the RBA into a 50bp rate hike, then it's highly unlikely Governor Lowe will return with a larger rate increment again in this cycle. The RBA continues to believe that it can best walk the narrow line on inflation and employment via a series of modest 25bp rate adjustments, even though this would likely mean that the rate cycle lasts for longer and that inflation remains above target for a protracted period.

The RBA's message on Melbourne Cup day was clear: "The Board has increased interest rates materially since May" and "The Board recognises that monetary policy operates with a lag and that the full effect of the increase in interest rates is yet to be felt in mortgage payments." They think that the pipeline of past interest rate increases is yet to be felt and that the impact of what is now 275bp of interest rate increases will put pressure on households and consumption, but without crushing the economy.

More interest rate increases are expected "over the period ahead" but unemployment is forecast to "remain around its current level over the months ahead."

The AUD was flat at US$0.64 despite weaker commodity prices, but a marginally weaker US dollar helped.

The Australian share market outperforms Global Peers in CYTD22 - 2nd in Local Currency and 1st in USD terms



Source: Morgan Stanley.

In October, the S&P/ASX 200 Accumulation Index finished up 6.0%. Industrials (+7.8%), outpaced Resources during the month (+1.5%, impacted by sharply lower iron ore prices). The Financials sector (up 12.2%) was the best performer by a mile, followed by Energy (+9.5%) and then Real Estate (+9.3%). The bottom three sectors were Consumer Staples (-0.2%), Materials (-0.1%), and Health Care (+0.6%).

For the month, the top stocks that made a positive contribution to the Index's return were: Commonwealth Bank (+122bps), Westpac (+63bps), National Australia Bank (+59bps), ANZ Banking Group (+44bps), and Woodside Energy (+42bps). Conversely, the bottom five stocks detracting from the Index's performance were: BHP Group (-27bps), Fortescue Metals (-18bps), CSL (-12bps), Rio Tinto (-10bps) and Medibank Private (-9bps).

The ASX Small Ordinaries finished up 6.5% and for a change, beat the broader benchmark by 0.5%. Within the ASX Small Ordinaries, the Small resources lagged, +3.8%. The best performing sub-index was the ASX A-REIT, up 9.9% which benefitted from the more dovish than expected RBA 25bps hike.

COMPANY SPECIFIC NEWS

The Market Hits

Novonix (NVX +52.3%)

Aspiring synthetic graphite producer NVX, which focuses on the battery anode, rather than lithium used in the battery cathode, was selected in the negotiation process to receive US$150 million in grant funding from the U.S. Department of Energy (DOE) to expand its domestic production of high-performance, synthetic graphite anode materials. The funding package announced by the DOE, is the first phase of over $7 billion in total provided by the President's Bipartisan Infrastructure Law for the battery supply chain. This supports NVX's execution of its strategic growth plan for synthetic graphite anode materials to be produced in the U.S. Specifically, the grant will be dedicated to the construction of a 30,000 tonnes per annum U.S. manufacturing facility, including site selection, plant layout and engineering design, with capability for additional expansion. After seeing its stock price down 86% from its November 2021 high, the grant funding news was a welcomed relief to investors.

Telix Pharmaceuticals (TLX +46.5%)

Renal and prostate cancer diagnostic imaging bio-tech company TLX reported 3Q US ILLUCCIX sales of US$36.4m, which was 20% above consensus. Together with some phase 3 data expected in November, it propelled the stock after a series of disappointing results this year.

Liontown Resources (LTR +26.5%) / Core Lithium (CXO +25.34%) / Lake Resources (LKE +18.4%)

These three lithium development companies were beneficiaries of the Solactive Global Lithium Index inclusion and subsequent ETF rebalancing, requiring around $300m of buying in illiquid names. They now join Mineral Resources, Allkem, Pilbara Minerals and Independence Group in the ~US$4bn Global X Lithium and Battery Tech ETF.

Domino's Pizza Enterprises (DMP +23.7%)

DMP bounced back, after falling 19% in the previous month, with no specific company news. However, a few of its global pizza peers posted some good 3Q numbers, which helped sentiment ahead of its early November update, squeezing out some of the shorts in the stock.

HUB24 (HUB +21.5%)

HUB reported a very strong start to its 1Q23, with custody platform FUA growing to $52.4bn, reflecting net inflows of $3bn, offset by market headwinds of -$0.3bn, or 0.7%. HUB also saw improved adviser growth over the quarter, despite market volatility. With HUB's existing deposit agreement with ANZ ending on 1 Dec 2022, the company announced a new deposit deal with Bank of Queensland from 2 December 2022, leading to a ~20-30bps reduction to its maximum cash management fee spread of 175bpts. This outcome was better than market expectations and was well received.

Perseus Mining (PRU +20.1%)

Gold miner PRU had a very strong 1Q operational performance with production 10% higher than forecasts and costs 20% lower. PRU also updated investors on its infill drilling program to upgrade resources and delivered a maiden 259koz ore reserve with its Yaoure underground pre-feasibility study. It augers well for the likelihood of maintaining production levels beyond 2026. This was one of the better gold quarterlies and investors pushed the stock up 15% higher than its peers.

Challenger (CGF +20.0%)

CGF released a positive 1Q23 update, with the key feature being total Life sales which were well ahead of expectations at $2.77bn, up 33% on the pcp. Challenger's 1Q23 suggested that it is comfortably on track to deliver more than the $8bn sales it needs in FY23 just to stand still. However, in the Funds Management business, FUM was down 3% QoQ with net outflows of $1.7bn (mainly redemptions in fixed income). CFG continued to guide to FY23 normalised NPBT of $485m-$535m and also announced the sale of its bank to Heartland Group (NZ headquartered), for $36m. The bank was divested for $36m, ~$1m more than it paid for the business less than two years ago. The asset sale had been flagged at the FY22 result when CGF announced a strategic review of the bank and was welcomed by investors. On the last day of the month, CFG also announced that its new CFO, Rachel Grimes was departing, which was unexpected given she only joined the group in May 21.

Link Administration Holdings (LNK +19.9%)

LNK shares re-bounded off a very low base after the Board updated the market regarding yet another, non-binding, conditional and indicative proposal received. The latest offer from Dye & Durham (D&D) was to acquire Link Group's Corporate Markets business and all of the BCM business for total cash consideration of $1.27 billion on a cash and debt free basis and based on a normalised level of working capital. LNK decided to engage with D&D on a non-exclusive basis to see if the conditional non-binding proposal could be progressed to a transaction that will provide sufficient value and certainty, on appropriate terms, to Link Group. Link also announced that it intended to commence a process to explore divestment options for the Link Fund Solutions business and had appointed Macquarie Capital and UBS Securities Australia Ltd as its advisers. Media speculation was suggesting that Superannuation manager Apex Partners was believed to have been running the ruler over the Retirement, Superannuation and Services business of Link Administration Holdings, worth about $1.5bn, "according to market analysts". Link Group chairman Michael Carapiet and his board were also cautioning shareholders against voting for a second strike at the group's upcoming AGM, saying the subsequent board spill meeting which would follow would be a "distraction" and costly.

The Market Misses

St. Barbara (SBM -31.1%)

Gold miner and perennial disappointer, SBM announced another poor quarterly production report and downgraded FY23 guidance, with 8% lower gold production and 13% higher costs resulting in ~40% lower EBITDA. Sell-side analysts slashed their valuations and its shareholders will be praying that speculated suitors, such as Genesis Minerals potentially comes along to put them out of their misery - SBM's share price is down 65% CYTD, one of the worst performing gold stocks.

Brainchip Holdings (BRN -25.9%)

Artificial intelligence company BRN released its third quarter results after the market close, reporting cash receipts of just US$118k and net operating cash outflows of $US3.8 million for the September quarter - not exactly what a company that had a $1.5bn market cap should be generating! The cash burn continues and with a cash balance of US$24.6m, makes an equity raising a likely conclusion. Shares in BRN plunged 21% on the day.

Megaport (MP1 -21.8%)

Global Software Defined Network (SDN) provider MP1, with an emphasis on cloud connectivity, released a disappointing 1Q FY23 global update, prompting another big sell off, in what has been a serial disappointer. Investors were clearly concerned over the higher capex spend and the cash burn looks worse, especially given the ports growth was worse. Expectations on a more meaningful ramp up in channel sales has been pushed out to 2H FY23, as onboarding of new partners continue, with market not taking these delays well. Bad update overall, stock was down -22% on the day.

Medibank Private (MPL -19.0%)

Contrary to earlier indications, MPL confirmed that customer data had been removed in its recent cyberattack and extended to its larger Medibank brand. This has significantly expanded the number of customers impacted from 1m to ~4m members. While it is far too early to gauge customer attrition and cost implications, MPL now expects to incur $25m-$35m of pre-tax non-recurring costs in 1H23, excluding further potential customer and other remediation, regulatory or litigation related costs. Just to re-cap, MPL identified unusual network activity on 12 October 2022 and took steps to contain the incident by engaging cybersecurity firms. The impacted ahm brand and international student policy management systems were temporarily taken offline. Subsequent press reports suggested initial access to MPL's systems was obtained by criminals through stolen login credentials. MPL initially indicated no customer data was compromised and expected negligible disruption or financial impact. However, with MPL confirming customer data across its larger Medibank brand had been accessed in addition to its ahm and international students businesses, it is estimated data relating to 4m members could be at risk. With MPL initially unaware multiple systems had been accessed and data removed, further reinvestment in IT systems appears very likely, however, the greater risk, is potential customer attrition and market share losses. With guidance on policyholder growth withdrawn, investors reacted accordingly and the stock finished down 18.1% after it came out of trading halt.

Adbri (ABC -14.4%)

Construction materials and lime producer ABC advised that its CEO was leaving and being replaced by an external appointment on an interim basis. It also provided a trading update, guiding to NPAT (excluding property) of $75-85m for CY2022, 15% below consensus forecasts, heavily impacted by ongoing wet weather conditions affecting volume and cost and an escalation of input and operational costs. The demand environment has remained robust, however, extreme rainfall events and ongoing inflationary headwinds, particularly energy and diesel costs, have continued to weigh on margins. While Adbri has implemented out-of-cycle price increases, they have not met ongoing cost inflation. In response to the current tough operating conditions, ABC were implementing further cost reductions, operational efficiency improvements, further contract re-pricing and accelerating its strategy to divest surplus land to realise value and recycle capital. Although some sell-side analysts raised concerns about balance sheet pressure, ABC are easily within their banking covenants with respect to both interest cover and gearing ratio and have around 70% of their debt hedged at relatively low interest rates.

Fortescue Metals Group (FMG -12.6%)

FMG was sold down in response to the 17% fall in iron ore prices during the month on the back of softening Chinese demand and underperforming its more diversified peers, BHP Group and Rio Tinto.

Magellan Financial Group (MFG -11.8%)

MFG experienced net outflows of $3.6bn in Sep-22, driving total FUM down to $50.9bn. Retail outflows slowed to $0.4bn ($0.6bn in Aug-22), while Institutional outflows of $3.2bn increased materially ($0.7bn in Aug-22). Approximately half of institutional outflows related to the liquidity requirements of one client impacted by UK gilt and currency market volatility in late September. Ratings house Zenith also placed a number of key Magellan Financial Group asset management products under review, citing "material" personnel changes. The move came after Magellan announced that chief executive David George would formally also take on the role of chief investment officer, as part of a string of other staff changes and new structure. Gerald Stack, portfolio manager of the Magellan Infrastructure Fund, was appointed deputy CIO. David George's vision at the AGM was to grow MFG into an asset manager with ~$100bn of FuM over the next five years. Investors viewed this as an ambitious strategy, driven by growth in lower margin products (e.g. Core Series), that will require a significant improvement in fund performance (especially in the Global Fund) and require impeccable execution on the launch of new capabilities. This typically takes years to build track records and attract meaningful FuM. MFG's balance sheet remains sound, with an estimated $900m of available capital to pursue growth options.

NIB Holdings (NHF -10.2%)

NIB announced that it had entered the NDIS plan management market, for which it undertook a capital raising (purchasing Maple Plan). The company also provided an update on 1Q23 operating profit that showed very benign claims (boosting profit yet again). NIB launched a fully underwritten $135m institutional equity placement (with a book build price of $6.90), plus a $15m non underwritten SPP. NIB said they were entering into the NDIS scheme starting with the purchase of Maple Plan, but did not disclose the purchase price (for commercial sensitivity reasons given more planned acquisitions - although the estimated price was ~$40m). Maple Plan is the 7th largest plan manager with 7000 participants and 60 staff (largely in Victoria). NIB stated the purchase would be EPS accretive, will meet their 15% ROIC hurdle, and is one of potentially 4-5 acquisitions in the space using the $150m new capital raised. Investors were somewhat more wary and the shares sold off.

Nickel Industries (NIC -7.6%)

NIC announced that Q3 EBITDA would be US$52-55m, lower than Q2 of US$103m and sell side analysts forecasts due to lower nickel pig iron (NPI) prices. The less transparent NPI price relative to the LME nickel price has typically been around 90-95%, but this relationship has now broken down somewhat over the last year with the correlation between NPI and LME prices falling to only ~60%. The massive growth in Indonesian NPI has been responsible, as NPI can only be used to make stainless steel and not battery grade nickel. This has been the major cause for NIC's 51% share price fall in 2022.

Bega Cheese (BGA -7.2%)

BGA announced that its Vitasoy Australia 51% joint venture partner, Hong Kong listed Vitasoy International, received FIRB approval to exercise its call option to acquire BGA's 49% interest. Vitasoy has a number 2 market position with a 26% market share and category growth of 12%, better than any of BGA's other categories. BGA's focus on the growing market importance of plant-based beverages and products faces a short term setback and it needs to assess its options as to whether it will continue its involvement in this sector. Either way, it didn't go down well with investors, although, at this stage, we don't yet know what price is being offered for BGA's 49% under the call option arrangement.

FUND PERFORMANCE

Equities rebounded sharply in October on the back of perceptions that central banks had done enough and are nearing the peak of policy tightening, lifting sentiment in share markets. The MSCI Developed Markets Index rose (+7.1%), and the S&P 500 gained (+8.1%) in local currency terms.

Against the above backdrop, the Fund's more defensive positioning could not keep pace and delivered a return of +4.6%, underperforming the ASX200 Accumulation Index return of +6.0%. This brings the CYTD return to -2.7%, modestly ahead of the ASX200 Accumulation Index benchmark which has returned -4.1%.

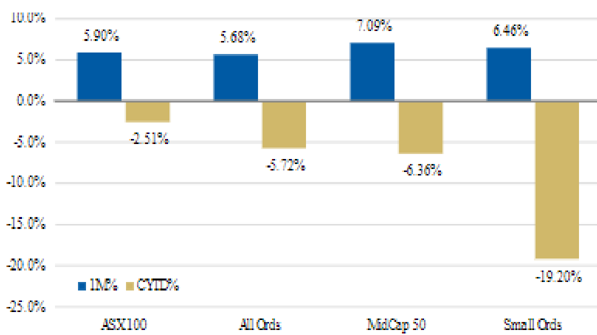
Major Banks outperformed the market in October on higher than expected NIM's with a return of +14.5%, significantly better than the benchmark return of +6.0%. This negatively impacted the Fund's monthly performance by 1.7%, as it holds no banks.

Investors also continued to chase battery stocks such as Novonix (+52.3%), Liontown Resources (+26.5%), Core Lithium (+25.3%) and Lake Resources (+18.4%).

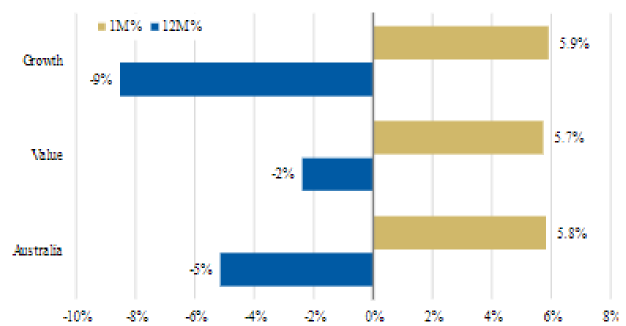
Large Cap stocks underperformed this month relative to their Mid Cap counterparts and Value lagged Growth. The Financials sector was easily the best performer (led by Commonwealth Bank), followed by Energy (Woodside Energy), and Real Estate (Goodman Group).

Materials and Health Care were two of the three weakest performing sectors. Consumer Staples closed down 0.2% and fared the worst (Woolworths Group was down 2.7%).

Large Caps outperformed in October and still lead CYTD



Value outperformed Growth in October



Source: Morgan Stanley.

Returns[1] (%)	*Gross*	*Benchmark**	*Excess*	*Net Return*
1 Month	4.62	6.04	-1.43	4.56
FYTD	3.09	6.45	-3.37	2.81
CYTD	-2.71	-4.12	1.40	-3.86
1 Year	1.33	-2.01	3.34	-0.04
2 Years (p.a.)	13.06	11.98	1.08	11.91
3 Years (p.a.)	8.43	4.82	3.62	7.21
Since Inception (p.a.)	9.48	6.32	3.16	8.29

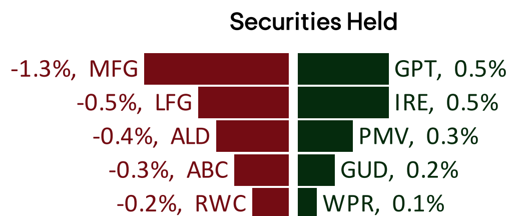
[1] The return figures are calculated using the redemption price for Class A Units and on the basis that distributions are reinvested. The Gross and Excess return figures are before fees and expenses whereas the Net Return figures are net of fees and expenses for the Class A Units. Returns of the Fund 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.

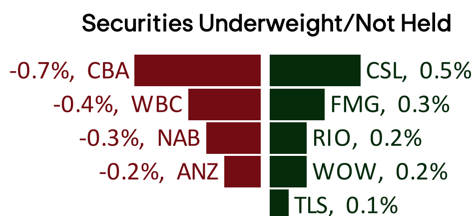
Past performance is not a reliable indicator of future performance.

Month of October Attribution

Securities Held



Securities Underweight/Not Held



Source: Ellerston Capital.

The main detractor to performance for the month was not holding any of the big 4 retail banks which rallied immediately after BOQ reported its FY22 result with a stronger than expected NIM of 1.81% for 4Q22. Our zero weight to Commonwealth Bank (CBA +15.4%), Westpac (WBC +16.8%), National Australia Bank (NAB +12.5%) and ANZ Banking Group (ANZ +12.1%).

Overweight positions in: Magellan Financial Group (MFG -11.8%), Liberty Financial Group (-8.9%), Ampol (ALD -5.3%), Adbri (ABC -14.3%) and (Reliance Worldwide (RWC -5.3%), also acted as a handbrake.

For the month, the main positive contributors that were not enough to offset the above, were active overweight positions in: GPT Group (GPT +12.5%), IRESS (IRE +13.8%), Premier Investments (PMV +11.0%) G.U.D. Holdings (GUD +8.5%) and Waypoint REIT (WPR +15.2%) and zero holdings in select large cap stocks that underperformed, namely CSL (CSL -1.6%), Fortescue Metals (FMG -12.6%), Rio Tinto (RIO -5.6%), Woolworths (WOW -2.7%) and Telstra (TLS +1.8%).

FUND ACTIVITY

Fund activity was rather subdued in the month of October. The Fund took profits in Northern Star Resources and Waypoint REIT, topped up existing holdings in Ampol (after a soft 3Q22 update), Treasury Wine Estates and Woodside Energy and G.U.D. Holdings was also introduced into the portfolio (see write-up below).

NEW STOCKS ADDED	STOCKS EXITED
• G.U.D. Holdings	

INCREASED	DECREASED
• Ampol	• Northern Star Resources
• Treasury Wine Estates	• Waypoint REIT
• Woodside Energy	

G.U.D. Holdings (GUD)

GUD manufactures, imports and sells automotive products, pumps, pool and spa systems mainly in Australia and New Zealand. GUD made a sizable acquisition, in late 2021, of Auto Pacific Group (APG), a leader in 4WD accessories and towing solutions – a business that principally supplies new vehicle sales. The semiconductor availability and other supply chain issues have plagued all auto manufacturers causing year over year new vehicle sales declines as order backlogs grow, which has negatively impacted APG in the short term. As a result, GUD downgraded guidance in June and hasn't really recovered since – underperforming the ASX 200 by 25% CYTD. We saw weakness as an opportunity and started buying GUD when it hit a 6 year low in October. We see the de-rating as a timing issue, not structural. GUD has generated consistently good EBITA margins ~20% and when OEM supply normalises, we felt the stock, which was only recently trading at ~$13.00, represented much better value in the low $7.0's. it will result in higher earnings and higher fully franked dividends. With GUD trading on a PE of 10x and a FF dividend yield of 6%, we can afford to wait.

FUND STRATEGY AND OUTLOOK

Front and centre are investor's pre-occupation with central bank policy direction, concerns about a global synchronised growth slow down and recession risk.

Fed Chair Powell stressed that interest rates could peak at "higher levels than previously thought", though officials could begin slowing the pace of increases as soon as their December meeting. At the press conference immediately after the Fed raised interest rates by 75 basis points for the fourth time in a row, Powell said "incoming data since our last meeting suggests that ultimate level of interest rates will be higher than previously expected." The FOMC signalled its aggressive campaign to curb inflation could be entering its final phase. While central bankers said that "ongoing increases" will still likely be needed to bring rates to a level that are "sufficiently restrictive to return inflation to 2% over time," fresh language was added to their statement. Powell suggested that it would be appropriate to slow the pace of increases "at some point." "That time is coming and it may come as soon as the next meeting or the one after that. No decision has been made", while stressing that "we still have some ways" before rates were tight enough.

The new language by the Fed comes amid still-strong readings on inflation and jobs, even as sectors like housing and manufacturing have slowed substantially. The Fed's unanimous decision lifted the target for the benchmark federal funds rate to a range of 3.75% to 4%, its highest level since 2008. Having been criticized for missing the stubbornness of the inflation surge, the Fed knows that monetary policy works with a lag and that the tighter it becomes, the more it not only slows inflation, but economic growth and hiring too. It's all about not fighting the Fed!

We received a similar prognosis from the RBA's - rates will rise but the size of the hikes will or have moderated.

In terms of market performance abroad, the following table decomposes the S&P 500 CYTD returns by sector and highlights that Energy has clearly been the outlier, but also that the more defensive sectors have outperformed, suffering lower earnings impact and significantly lower PE compression.

The top 5 contributors to the S&P 500 CYTD return are: Exxon Mobil (+81%), Chevron (+54%), Eli Lily (31%), ConocoPhillips (+75%) and Merk & Co (+32%) with a combined contribution of +1.53%, whilst the 5 largest detractors are Microsoft (-31%), Meta Platforms (formerly Facebook -72%), Alphabet (formerly Google -35%), Amazon (-39%) and NVIDIA (-54%) with a combined negative contribution of -7.4%!

S&P 500 Return Decomposition – CYTD

	Revenue*	Margin*	Earnings*	Buybacks	EPS*	P/E	Price Return	Dividends	Total Return
S&P 500	7.3	-4.0	3.0	0.7	3.8	-21.7	-18.8	1.3	-17.7
Energy	31.7	37.7	81.4	0.9	83.0	-10.8	63.2	3.3	68.6
Staples	6.8	-5.5	0.9	0.3	1.2	-7.0	-5.9	2.1	-3.9
Utilities	7.6	-3.2	4.2	-0.3	3.9	-10.2	-6.7	2.3	-4.6
Health Care	4.1	-6.4	-2.6	0.6	-2.1	-3.9	-5.9	1.4	-4.6
Industrials	4.0	0.2	4.2	1.0	5.2	-15.3	-10.9	1.3	-9.7
Financials	15.4	-9.7	4.3	1.6	6.0	-18.1	-13.2	1.7	-11.8
Materials	4.4	-8.5	-4.5	1.2	-3.3	-15.4	-18.2	1.6	-16.9
Technology	2.8	-3.1	-0.4	0.5	0.1	-26.8	-26.7	0.8	-26.1
REITs	8.9	0.2	9.2	-2.0	7.0	-33.7	-29.1	2.4	-27.4
Discretionary	3.8	-8.0	-4.5	1.3	-3.2	-27.9	-30.2	0.7	-29.7
Comm Svcs	0.2	-14.7	-14.5	0.3	-14.3	-29.4	-39.5	0.9	-39.0

*Change in forward estimates. Source: Credit Suisse

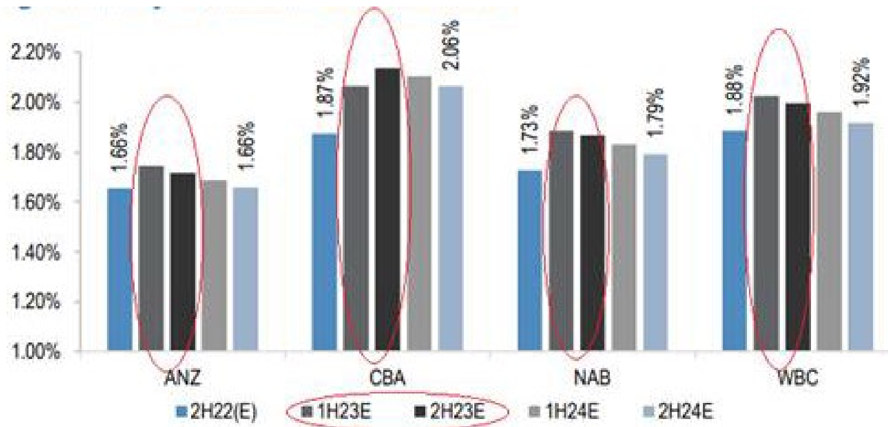
The Fund holds no banks (as we seek better opportunities elsewhere), but this was the major cause of October's underperformance, so we thought we should again put forward our medium term outlook and investment thesis on the banking sector.

In summary, structural pressures in the industry are to play out over medium term: NIM tailwinds will abate, credit growth will continue to slow, house prices will peel off further and Bad and Doubtful Debts (BDDs) will rise (from a benign level currently) and earnings will turn down.

*Major bank net interest margins (NIMs) are likely to be up ~20bps in the current 2H22 reporting season as there is a lag between mortgage rate pass through and cash deposit rate adjustments (before NIMs fall away - **todays gain vs. tomorrow's pain**).*

When do NIMs Peak? Probably in the next half!

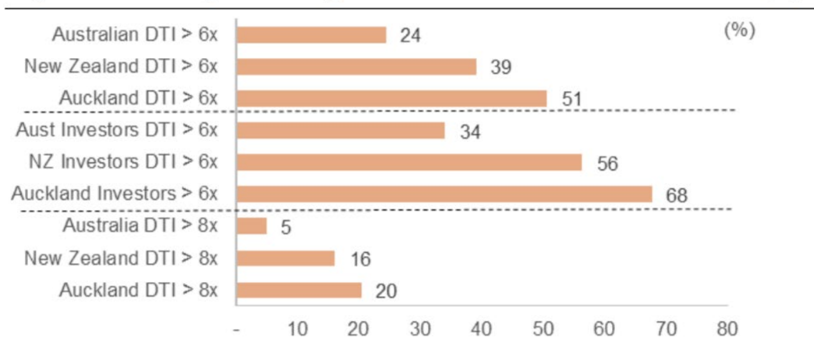
Majors headline NIM forecasts



Source; JP Morgan

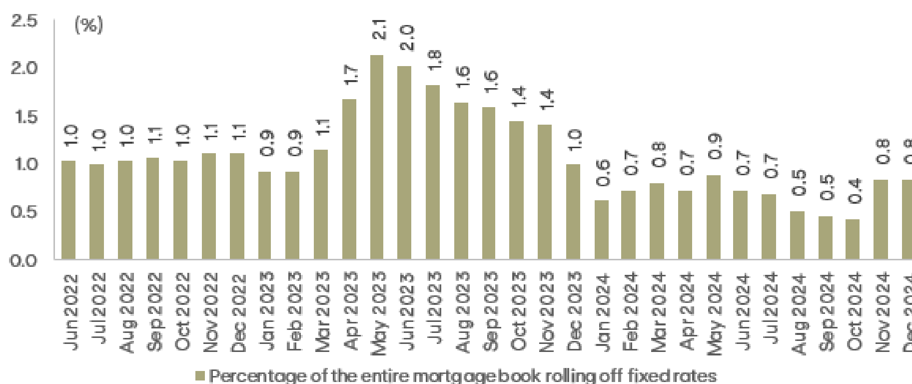
Lending to highly leveraged borrowers during the pandemic drove an increase in credit risk within the banks

Customers who borrowed at 'very high' Debt to Income



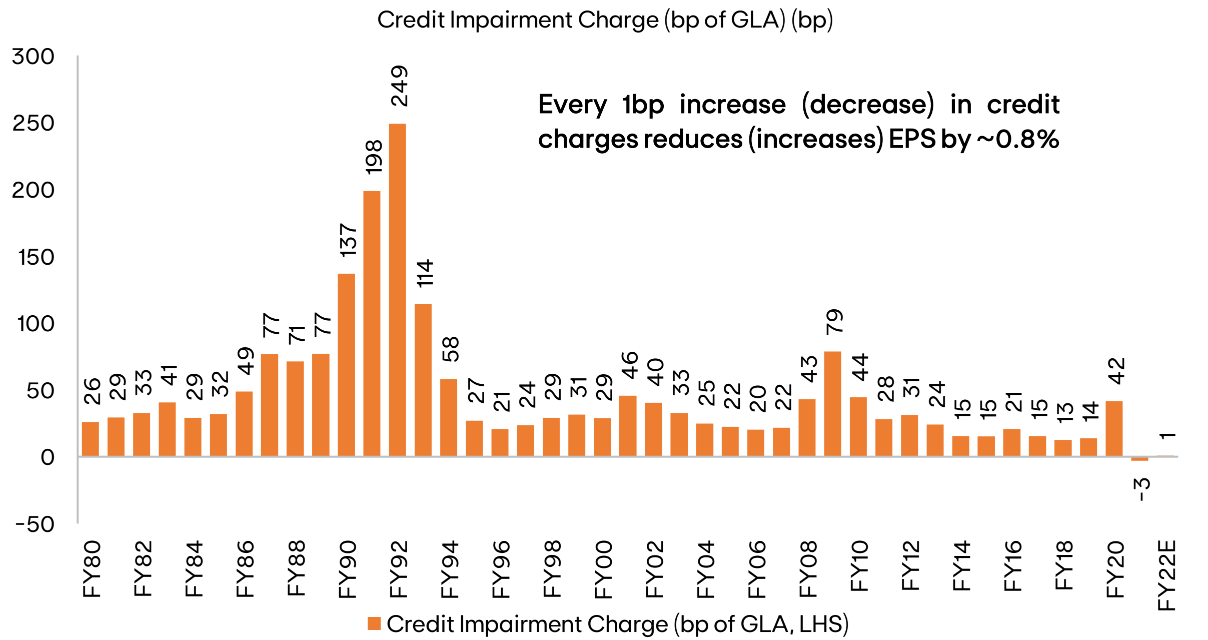
Fixed rate maturities to accelerate in April/May 2023.

This delays the impact of rising rates on the economy

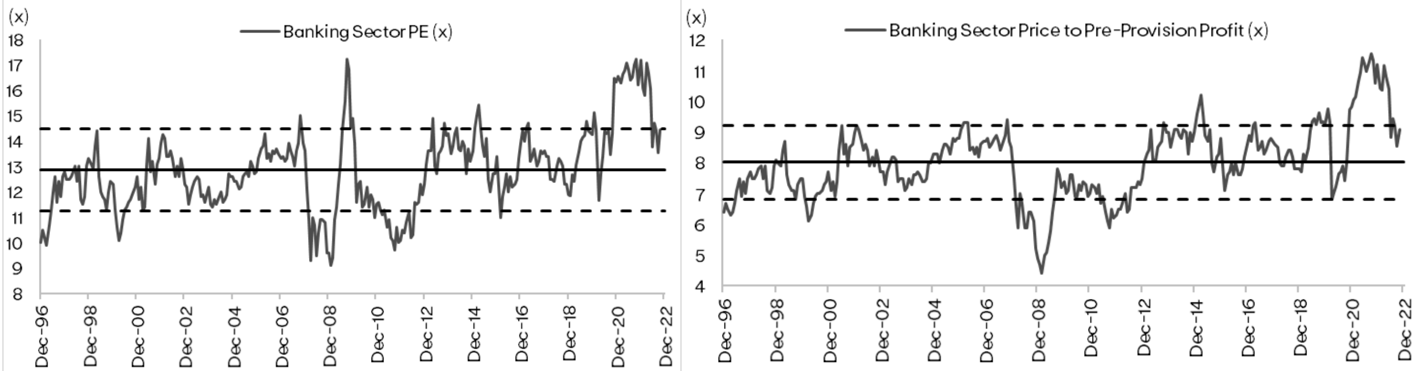


Source: Barrenjoey

Credit losses are at record low levels despite record leverage

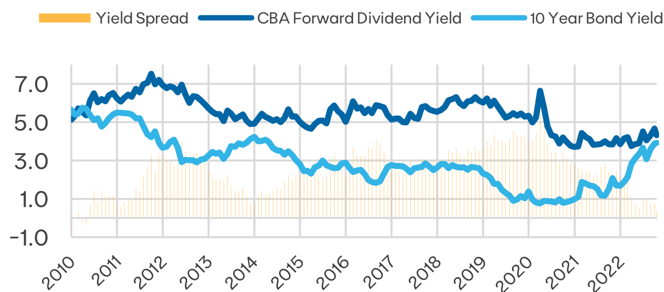


Valuations are not cheap enough yet, even before credit risks play out

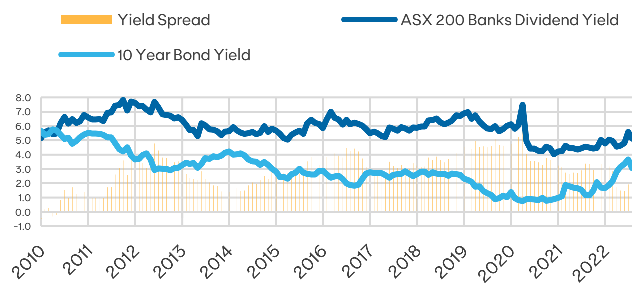


With higher interest rates, yield spreads are again converging

Commonwealth Bank Dividend Yield vs Bond Yield



Banks Dividend Yield vs Bond Yield

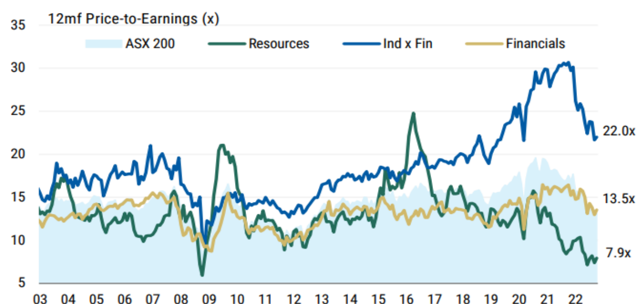


Source: Macquarie

Structural pressures in the industry to play out medium term: NIM tailwinds abate, credit growth slows, Bad and Doubtful Debts (BDDs) rise and earnings turn down.

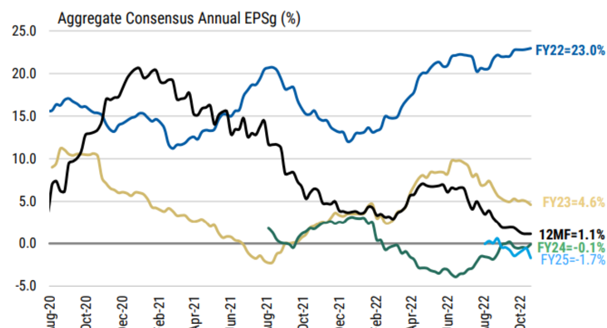
The Australian equity market has again proven more resilient than its global peers. The domestic market multiples have de-rated meaningfully over the past year, with the 12MF P/E now standing at 13.1x. Industrials ex-Financials have compressed to 22.0x from 30.2x whilst outer-year earnings growth expectations stay fairly anchored in the low-single-digit territory. Resources have fallen from 9.9x to 7.9x through 2022.

Valuation: the 12M forward PE of the Industrials ex-Financials has Fallen from 30.2x to 22.0x



Annual

Consensus EPS Growth Trends FY21-24



Source: Morgan Stanley Research.

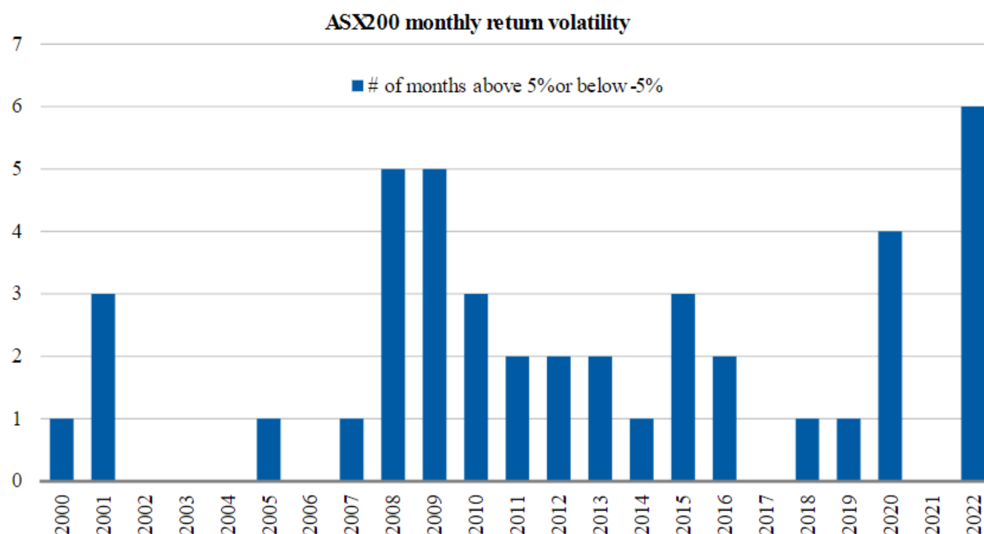
The investment climate still remains foggy and volatile: the US Fed is adamant that it must "keep at it until the job is done" so rates will go higher and a slow-down will ensue, with the unknown being the size and duration. There will inevitably be more months like October, as we transition from the post GFC era of globalisation, fiscal discipline, QE, zero rates and low taxes to one of nationalism, fiscal panic, QT, higher interest rates and taxes plus a renewed world of Cold War geo-politics.

The Fed seems to be in a position where on the one hand, Powell argued that the pace of tightening could ease as early as the next meeting and given that monetary policies work with a lag, the Fed needs to carefully assess the cumulative impact of rate tightening implemented over the past six months. He also alluded to the fact that if there are signs of overtightening, the Fed is ready to pivot quickly and support the economy. On the other hand, he argued that if the Fed under-tightens, inflation could become imbedded, a bad outcome. This is a similar predicament in which other Central Banks find themselves.

The only conclusion we can reach is that in the "twilight zone" we are currently in, between tightening, pivoting and easing, is a recipe for confusion and will no doubt lead to elevated volatilities in the months ahead.

We have not been surprised to see powerful short lived relief rallies, as October likely was. As you can see in the chart below this year, and as we keep saying buckle up, as it's going to be a bumpy ride!

Monthly volatility has been high in 2022 with 6 out of 10 months above 5% or below -5%



Source: Morgan Stanley Research.

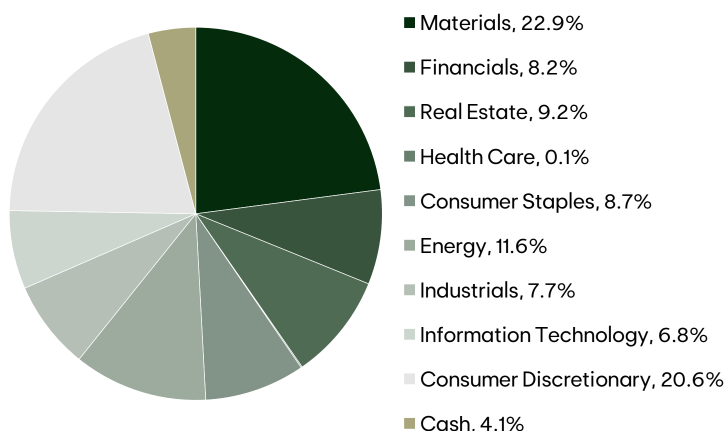
Portfolio Characteristics

FY23(E) Key Portfolio Metrics	Fund	Benchmark
Price/Earnings (X)	11.4	13.4
Dividend Yield (%)	6.5	4.7
Grossed Up Dividend Yield (%)	8.5	6.2
Dividend Growth Rate (%)	-0.9	0.9
Beta	0.87	1.00

TOP 10 HOLDINGS	
GPT GROUP	9.1%
BHP GROUP	7.9%
PREMIER INVESTMENTS	7.5%
IRESS LIMITED	6.8%
WOODSIDE ENERGY	6.4%
HARVEY NORMAN	5.9%
AMCOR	5.4%
TREASURY WINES	5.0%
LOTTERY CORP	4.8%
AMPOL	4.4%

MARKET CAPITALISATION

SECTOR ALLOCATION



Source: Ellerston Capital.

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Find out more

For new or additional applications into the Fund, please click here.

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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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