

# Ellerston Equity Income KIS Fund

Monthly Newsletter, November 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	\$1.0459
Net Asset Value	\$1.0433
Redemption Price	\$1.0407
Liquidity	Daily
No Stocks	31
Strategy FUM	\$23.3m
Management Fee	0.70% p.a.
Performance Fee	10%
Buy/Sell Spread	0.25% on application 0.25% on redemption
Minimum Investment	\$10,000
Minimum Additional Investment	\$5,000
Distribution Frequency	Quarterly

## PERFORMANCE SUMMARY

Performance	1 Month	FYTD	1 Year	2 Years (p.a.)	3 Years (p.a.)	Since Inception (p.a.)^^
Net^	4.31%	7.24%	3.21%	10.54%	6.88%	9.37%
Benchmark*	6.58%	13.46%	5.00%	10.12%	5.93%	8.07%
Alpha	-2.27%	-6.22%	-1.80%	0.43%	0.95%	1.30%

^ 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.

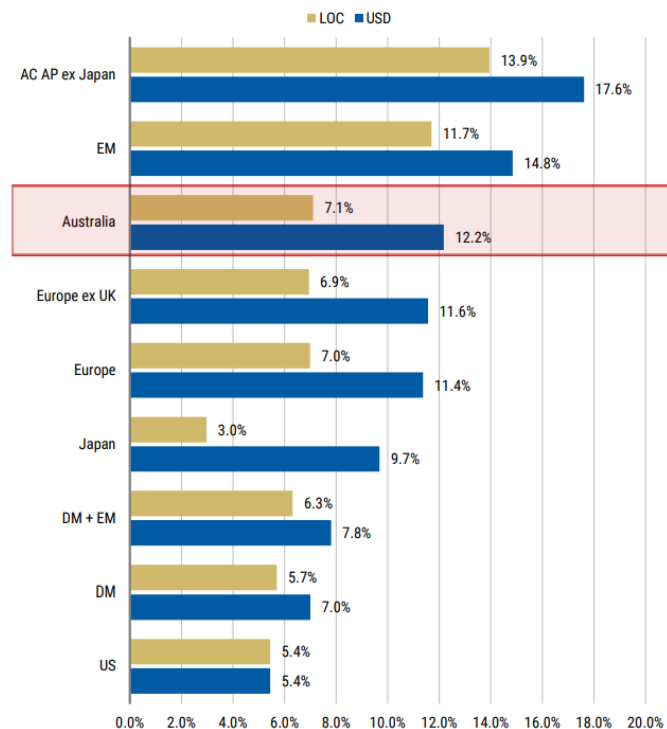
## MARKET OVERVIEW

Global equity markets enjoyed another strong month in November as Federal Reserve Chair Powell's comments on potentially slowing the pace of rate hikes "as soon as December" provided relief to markets. The MSCI Developed Markets Index rose (+5.7%), the S&P 500 gained (+5.5%) in local currency terms and Emerging Markets took off (+11.7%) on tentative signs of re-opening in China.

Materials, Industrials and Financials were relative outperformers, with IT, Consumer Discretionary and Communication Services sectors, faring the worst.

Locally, the S&P/ASX 200 outperformed the DM World, as the rebound in commodities propelled the resources sector, driving our market higher.

MSCI Global Country/Regional Indices in November 2022



Source: Morgan Stanley.

## USA

Economic indicators continued to soften in November, inflation eased up and employment data remained elevated, albeit also starting to slow. Stronger than expected October nonfarm payrolls of 261K jobs, which exceeded market forecasts of 200K was the weakest reading since December of 2020. However the figures continued to point to a strong but slowing labour market, as labour shortages persist in the US. The much anticipated October core CPI fell to 6.3%, against a 6.5% consensus forecast and 6.6% prior, with the core PCE price index - the Fed's preferred inflation measure - falling from 5.2% to +5.0% YoY. This data point raised the odds of a 50bps hike at the December FOMC meeting.

The Dow Jones Industrial Average continued its outperformance rising 6.0%, the S&P 500 finished 5.5% higher, with the NASDAQ Composite Index the laggard, posting a 4.5% rise as a number of big tech names continued come off the boil on disappointing 3Q revenue and earnings updates.

## Europe

The Euro-zone economy is clearly headed for a recession based on the November PMI data which is still flashing red. The composite gauge rose from 47.3 to 47.8, its second lowest reading since April 2013 (excluding COVID lockdown months). Manufacturing was weak (47.1, down from 48.6), with Services printing flat at 48.2, but likewise in contractionary territory.

The ECB meets in December and another 75bps hike is likely in December, especially against the backdrop of record high inflation of 10.6% YoY in October, despite posting a lower rate of 10.0% in November.

The Euro STOXX50 Index finished the month very strongly, up 9.7%. Among the major exchanges, Germany's DAX rose 8.6%, France's CAC 40 was 7.6% higher and UK's FTSE 100 ended up 7.1% higher.

## Asia

Tentative signs of re-opening in China, such as easing of travel and quarantine restrictions, the scrapping of PCR testing requirements in top-tier cities and suggestions that dynamic zero-coronavirus policy would be further nuanced in terms of its application, led the A-share market sharply higher in response. China's 20-point stimulus plan designed to support the property market also helped sentiment, however towards month end, the recovery in Chinese and Hong Kong stocks plateaued on renewed concerns about COVID-19 lockdowns, protests against the nations stringent polices and significant capital outflows from Hong Kong.

Asian equity markets were a mixed bag, with the Hang Seng being the standout jumping a staggering 26.8%, the China SSE rose 9.8%, Korea's KOSPI was up 7.8%, followed by India's SENSEX +3.9% and the Nikkei 225 was the laggard, up 1.4%.

## Commodities

Commodity prices were stronger across the board, with China's stimulus and accelerated shift towards reopening the economy buoying sentiment. Iron ore was the major winner, with the price up 7% to US\$101/tonne. The Brent oil price fell 10% to US\$85/barrel on demand destruction concerns. Natural gas prices bounced back, as weather conditions deteriorated - European TTF spot gas prices rose a staggering 74% to US\$42/MMBtu and the JKM spot LNG price ended 21% higher at US\$33/MMBtu. This price action also helped to drag up thermal coal prices by 12% to US\$398/tonne. The base metals complex was also very strong, with the major metals; aluminium up 10%, copper was 9% higher and nickel rose 24%. Gold was 8% higher at US\$1768/ounce as US bond yields and US dollar quickly reversed course.

## Bonds

US bond yields rallied hard on weaker inflation data and signalling by key FOMC members that the pace of rate hikes could slow "as early as December". The US 10-year yield fell 40bps to 3.65%. Australian 10-year bond yields also fell 23bps in sympathy to 3.53%, given the more recent dovish stance by the RBA.

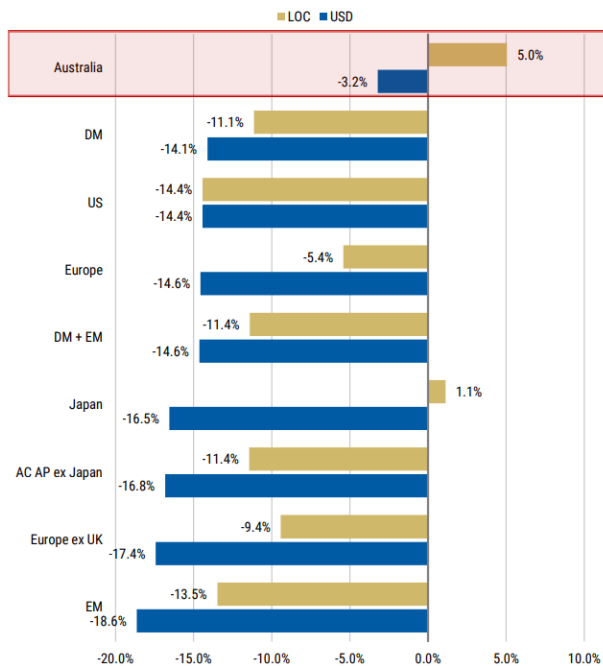
## Australia

The RBA, delivered another 25bp interest rate increase (the 7th in a row) on Cup day to 2.85%. Later in the month, Governor Lowe apologised to Australians for giving them unclear guidance, leading to what the press described as "hundreds of thousands taking out big mortgages in the expectation that interest rates would stay low until 2024". Safe to say that 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.

Across the Tasman, the RBNZ's uber hawkish 75bp rate hike and Monetary Policy Statement were intended to quickly quell inflation and further restore the RBNZ's inflation-fighting credentials. The collateral damage to the economy will very likely be an economic recession and materially higher unemployment next year. The RBNZ's aggressive actions risk overdoing short-term economic harm, particularly as in the medium term, disinflation pressures are looming on the horizon. The NZ dollar rose 8% against the greenback and 2% versus our Australian dollar.

The AUD closed the month up 6% to US\$0.68 given stronger commodity prices and a much weaker US dollar.

## The Australian share market outperforms Global Peers in CYTD22 - in both Local Currency and USD terms\*



Source: Morgan Stanley, \* MSCI Global Country/ Regional Indices Performance

**In November, the S&P/ASX 200 Accumulation Index finished up 6.6%.** Resources (+14.6%, impacted by sharply higher commodity prices), significantly outpaced Industrials during the month (+3.8%). The Utilities sector (up 20.8%) was the best performer by a mile due to the Origin Energy takeover offer, followed by Materials (+16.3%) and then Health Care (+6.0%). The bottom three sectors were Communication Services (+2.1%), Financials (+2.5%), and Energy (+2.7%). For the month, the top stocks that made a positive contribution to the Index's return were: BHP Group (+204bps), CSL (+46bps), Fortescue Metals (+40bps), Rio Tinto (+39bps) and Commonwealth Bank (+26bps). Conversely, the bottom five stocks detracting from the Index's performance were: James Hardie Industries (-11bps), Aristocrat Leisure (-6bps), Xero (-5bps), Pilbara Minerals (-5bps) and Santos (-5bps).

The ASX Small Ordinaries finished up 4.9% and for a change, trailed the broader benchmark by 1.7%. Within the ASX Small Ordinaries, the Small Industrials lagged, +2.7%. In small cap land, City Chic (CCX) provided a shocking update and the shares slumped 39.08%. The best performing sub-index was the ASX Gold Index, up 18.2%, benefitting from the 8% move in the precious yellow metal.

## COMPANY SPECIFIC NEWS

### The Market Hits

#### Sandfire Resources (SFR +45.2%)

Copper producer SFR had a stellar run during the month driven by a 9% rally in the copper price, a capital raise to strengthen the balance sheet, the OZ Minerals (OZL) board recommended takeover by BHP and a popular appointment as the new CEO. After the strong price move in copper, SFR made an opportunistic \$200m raise to give the company balance sheet flexibility which had been a key concern for investors. The coincidence was that it was done on the same day as the BHP/OZL deal was agreed, which left SFR as the largest copper exposure still standing. A refreshed management team following a senior South32 executive appointment as CEO, ticked the final box for investors.

#### Origin Energy (ORG +41.1%)

ORG shares shot up after the company received a non-binding knockout cash offer at A\$9 per share from the Brookfield/EIG Consortium, pitched at a 55% premium to the last close. The conditions seemed pretty standard (due diligence, ACCC and FIRB approval etc.), however the price will need to be reduced by amount of any dividend paid by ORG before completion of the deal. If it does not complete by May 15th 2023 (i.e. six months), the offer will be increased by 3cps per month (equivalent to 6% pa). By way of background, ORG had previously received indicative offers from the Consortium of A\$7.95 on 8 Aug and A\$8.70-\$8.90 on 18 Sep. The ORG board stated that it will unanimously recommend the offer if the bid becomes binding and the due diligence period is expected to conclude in eight weeks. The scheme documents should be progressed in parallel, so a binding offer seems possible from late January, pending all the Government approvals. The consortium has a no shop/no talk exclusivity for 39 days. Brookfield intends to acquire the Energy Markets (utility) business given its existing interest in the Australian merchant utility sector, having recently bid for the majority of AGL with Grok. Newswire services later reported that Brookfield intended to invest an extra A\$20bn in Origin for energy transition. MidOcean (the vehicle used by EIG) intends to buy the Integrated Gas (upstream) business, which seems plausible given EIG tried to buy 10% of APLNG when ORG sold down a year ago, but was pre-empted by ConocoPhillips. Both bidders are highly credible and based on the premium paid, want the deal to happen - only time will tell.

#### Champion Iron (CIA +39.0%) / Fortescue Metals Group (FMG +31.8%)

Iron ore producers bounced strongly as the iron ore benchmark price jumped 27% during the month on the prospects of less stringent COVID-19 restrictions in China, substantial property policy initiatives and tight port inventories. CIA and FMG are both lower margin producers and therefore more leveraged to higher prices, which saw them outperform their larger cap peers BHP (+21.8%) and Rio Tinto (+24.3%).

#### Nickel Industries (NIC +33.6%)

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 for this breakdown, 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.

#### Evolution Mining (EVN +29.3%) / Gold Road Resources (GOR +29.2%) / Regis Resources (RRL +26.6%)

Gold producers benefitted from the 8% recovery in the gold price to US\$1768, driven primarily by a weaker US dollar and lower bond rates, putting a rocket under the gold stocks which had significantly underperformed the gold price and the equity market this year.

#### Coronado Global Resources (CRN +25.7%)

Coal producer CRN released its September quarter results with slightly weaker volumes, but significantly higher price realisations, resulting in stronger cash generation and prompting the company to declare another special dividend of US13.4c, which is a massive 6.8% yield just for the quarter.

#### Virgin Money UK (VUK +25.6%)

The VUK share price surged 14.9% in London after announcing a stronger FY22 result that came in 6% ahead at the profit line, albeit due to much lower impairments. The update was largely in line at the pre-provision operating profit (PPoP) level, however, pleasingly for investors, the FY22 NIM of 1.85% came in at the top-end of previous guidance expectations. FY23 guidance was also ahead of consensus, with NIM targeted at 185-190bps (consensus was sitting at 1.85%). Importantly, VUK also highlighted tailwinds into FY24, with benefits from its hedge book and mix expected, as it continued to anticipate growth in SME and personal lending over mortgages. VUK also noted that it expected its cost of risk for FY23 to normalise towards its through the cycle average of ~30-35bps, a Cost-Income Ratio of ~50% in FY23, growth in overall lending in FY23 (Cons. +2-3%), modest growth in Mortgages and a CET1 ratio of above 14% (Cons. 14.6%). The capital management carrot was further dangled, with VUK commencing a £50m buyback extension which was effective immediately. There was enough in the result to propel the bombed out shares which trade at 0.4 times price to book, consistent with other lenders in the UK.

## The Market Misses

### Collins Foods (CKF -18.6%)

CKF which operates restaurants under the KFC, Taco Bell and Sizzler brands reported its 1H FY23 results, highlighting how it is bearing the full brunt of inflationary pressures and trying to hold the line on menu prices. CKF is navigating severe inflation across most cost lines from chicken and chips to oil and lettuce, however, cost pressure from higher energy and staff expenses are much harder to pass on. While some input costs look to have peaked, management flagged that they expect increased pressure in 2H23/FY24, which creates a challenging growth outcome. CKF also announced the once promising roll out of the Taco Bell chain in Australia would be halted for a review, as its sales were sinking. Sell-side analysts lopped off 20-25% from their earnings forecasts for FY23/24 and investors voted with their feet with the stock falling 20% on the day. The shares which were trading above \$13.00 in January, closed at \$7.65 and have been a massive underperformer.

### Elders (ELD -18.4%)

ELD reported a strong FY22 result in line with the top end of its previous guidance (underlying EBIT +39.4% vs guidance of 30% - 40% growth), however, NPAT missed consensus expectations. The update was overshadowed by the uncertainty created by the recent heavy rainfall in some cropping regions on the eastern seaboard and by sudden management changes, with well-regarded CEO Mark Allison set to retire by 14 November 2023. Given the CEO is highly respected and has had a strong track record, this caused a negative market reaction, with the stock selling off sharply on the day. EBIT growth of 39.4% was underpinned by favourable seasonal conditions, strong livestock pricing, a buoyant real estate market, execution of its backward integration strategy and recent bolt-on acquisitions. Not surprisingly, EBIT growth materially slowed in the 2H22 vs 1H22 at 7% vs 80%, with ELD actively managing its 2H margins given certain key product prices (e.g. glyphosate) fell away. Operating cashflow conversion of 75% was also however significantly weaker than guidance of 90%, given higher inventories. The FY22 result crystallised a very strong 3-year period for ELD (underlying CAGR +39%), as the outlook by ABARES (whilst still buoyant), is not expected to reach the levels delivered in FY22. ELD's FY23 growth target of 5-10% was reiterated, but investors took the view that it would be tough to comp these numbers, as last year's ideal conditions start to normalise. As industry tailwinds soften, management changes (CEO and CFO) and recent unfavourable weather events have clouded the near term outlook.

### Novonix (NVX -16.4%) / Pilbara Minerals (PLS -8.4%)

Lithium producer PLS which focuses on the battery cathode and aspiring synthetic graphite producer NVX, which focuses on the battery anode were both under pressure, driven by concerns around battery de-stocking in China. This started with major Chinese battery manufacturer CATL announcing that it was going to step on the brakes and reduce its purchases of upstream lithium salts. CATL concerns revolve about next year's demand prospects, with the supply chain drawing down inventory rather than making new purchases - production across the supply chain is normal at present, but buffeted by subsidies that will cease on 31 December. Given the recent massive price rises for NVX and PLS in the previous month of October at +52% and 12% respectively, investors took profits given the uncertainty associated with the great battery juggernaut.

### Healius (HLS -15.2%)

Healius released an underwhelming trading update for July to Oct 2022, confirming materially lower pathology margins due to cost pressures and the rapid drop in COVID-19 testing demand. Whilst revenues from the group's core diagnostics operations were broadly in line - imaging was stronger, up 9.9%, with management attributing the above market growth to public sector contract wins, EBITDA margins were crunched to 20.1%. COVID-19 testing had fallen away much more rapidly than consensus expectations (surprise, surprise) and margins were more than 500bps lower than consensus forecasts, as the slower rate of COVID-19 testing made navigating high cost capacity more challenging. Management also called out other headwinds to its core lab business, including higher test ordering by GPs which drove higher costs, as the labs could only bill for the three most valuable tests. This result was in stark contrast to December 2020, where HLS guided to materially higher expected margins by FY23 - targeting \$80m of additional earnings, mainly from costs savings and efficiencies. In a higher post-COVID inflationary environment with limited pricing power, investors quickly lost faith that this level of improvement could be achieved. One month on from the AGM, the company abandoned its intention to provide FY23 guidance, given uncertainty of the "timing, speed and shape of the expected reversion to long-term growth trends". This shook investor confidence and coupled with sell side profit downgrades that ensued in the order of 30-50%, the shares sold off.

### James Hardie Industries (JHX -14.1%)

Very well held market darling JHX sold off sharply following a weaker than expected 2Q23 result, with investors hoping this will be the last downgrade. Despite the US delivering 27.1% margins (FY guidance of 28-30% implying a 380bps acceleration), the 2Q23 update was clearly disappointing, with misses across all segments. JHX updated its FY23 outlook, lowering NPAT guidance to US\$650-710m, which at the mid-point was down 10% from its prior FY23 guidance (US\$730-780m). Also concerning was the board's strange move away from paying unfranked dividends and the introduction of a US\$200m share buyback program in place of the dividend, equivalent to ~2% of its market cap. With housing conditions deteriorating and new industry capacity coming online, the headwinds were building. A sharp deterioration in new home starts in the past 45 days led JHX to now anticipate 2HFY23 volumes falling by 30%. Renovation and repair (R&R) was expected to remain more resilient, with management guiding to flattish growth in 2HFY23, leading to a 5-8% overall volume decline. The stock traded ~6% worse than the downgrade on the day, the abrupt change in the outlook statement being the main culprit. Management commentary suggesting that the 6-month backlog had "vanished" since its recent update in September, caught investors totally offside. Post the update, the sell-side took a knife to profit expectations and revised FY24e down ~20%.

### **Lendlease Group (LLC -12.4%)**

LLC had a strategy briefing which guided to the lower end of divisional return targets for FY23. This was driven by a combination of the macro environment headwinds and asset specific delays, with particular concern being the lowering of expectations in the more resilient investments division. Earnings forecasts were wound back, again with the stock down 9% on the day and down ~29% for the CYTD. The dog ate my homework and the tram had a flat tyre again for the past 20 years.....

### **Xero (XRO -9.5%)**

Accounting software provider XRO delivered a weak 1H22 profit result, which was a 12% EBITDA miss and subscriber additions whilst weaker than expected, were bolstered by ANZ substantially - International was also much weaker. Costs were much higher in 1H22, but XRO are guiding to the low end of their cost guidance for FY23. XRO also announced a new CEO appointment to take over the reins from Steve Vamos, who is retiring after five years. The news combination was enough to push the price down 11% on the day.

### **National Storage REIT (NSR -8.4%)**

NSR's AGM update highlighted RevPAM (revenue per available square metre) growth slowing, driven by increasing rates, which offset decreasing occupancy. The group rate increased 2.3% to \$302, while occupancy declined 0.6% to 87.9%. As a result, a few sell-side analysts downgraded their rating, especially given NSR has performed strongly over the past 24 months. They highlighted the risk of a downturn in self-storage fundamentals as consumer sentiment softens and supply comes online and NSR is trading at elevated levels compared to peers.

### **Domain Holdings Australia (DHG -8.4%)**

DHG gave a 1QFY23 trading update at their AGM with listings a +4% softer than their expectations and referenced this trend to continue in 2QFY23. Costs were also under review, given the tough macro environment, resulting in DHG reducing its FY23 EBITDA margin guidance to a low single digit percentage point decline on an ongoing basis (previous guidance was flat), driving earnings downgrades of ~10%.

### **City Chic Collective (CCX -39.1%)**

In the smaller cap segment of the market, the standout was City Chic (CCX) which collapsed after it provided a trading update in conjunction with its AGM, reflecting heightened concerns surrounding the consumer outlook, particularly in the Northern Hemisphere (56% of FY22 sales). Headwinds to earnings are unlikely to abate in the short term. Neither first half or full year guidance was provided, but Group sales for the first 20 weeks were tracking well below market forecasts and updated commentary on gross margins and costs led to material downgrades across the Street. Margins were materially below expectations, with City Chic attributing the decline to increased competitor discounting, higher promotional activity and rising fulfilment costs. Investors seem particularly concerned about the sustainability of pure online plays in this retail category post COVID-19, the health of the core customer base in North America and management's near-term ability to fix its problematic EMEA business. While revised forecasts now factor in a net cash position for FY23 (due to reasonable cash conversion and inventory reduction expected due to discounting and clearing in 2H23), a poor Black Friday/Cyber Weekend/Christmas trading period could result in further balance sheet pressure. Basically, it was a disaster, investors have lost confidence in the stock and headed for the exit.

## FUND PERFORMANCE

Equities continued rallying in November on the back of falling bond yields and light at the end of the tunnel for China's restrictive zero-COVID policy. Weakness in the US dollar, as bond yields fell, was a boost to commodities, also driven by stimulus measures announced in China and the relaxation of certain lockdown restrictions.

For the past few months, the Fund's more defensive positioning and underweight stance in resources (BHP being our main exposure) meant the strategy could not keep pace, delivering a return of +4.4%, lagging the ASX200 Accumulation Index return of +6.6%.

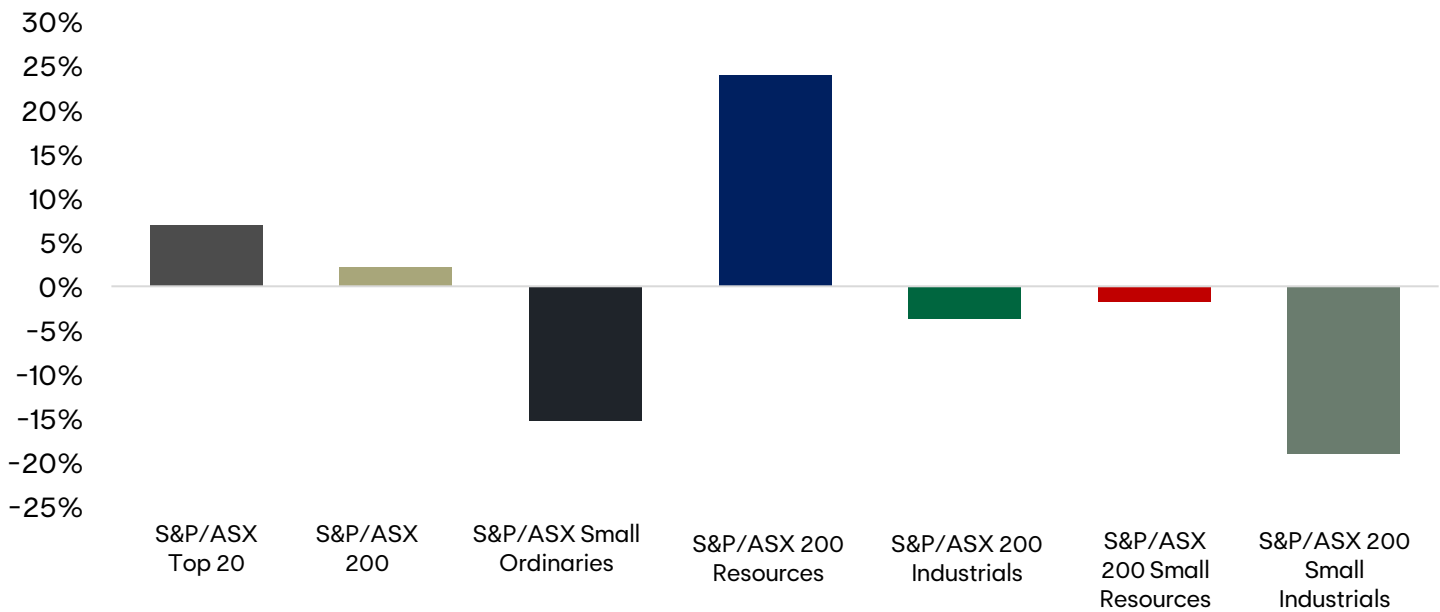
Materials which rose 16.3%, significantly outperformed the market in November, having benefitted from higher across the board commodity prices.

Large Cap stocks also outperformed this month relative to their Mid Cap counterparts, however Value outperformed Growth. The Utilities sector was easily the best performer (led by Origin Energy, +41.1%), followed by Materials (Fortescue Metals, +31.8%) and Health Care (CSL +7.0%). The dividend yield on CSL is only 1.2%, thus we don't own any shares.

Energy and Financials were two of the three weakest performing sectors. Communication Services closed up 2.1% and fared the worst (EVT, formerly Event Hospitality and Entertainment was down 7.5%).

For the CYTD, there has been a huge disparity between the performance of Large Caps and their Small Cap peers. The S&P/ASX 200 Resources Sector has outperformed the S&P/ASX200 Industrials Sector by an astonishing 27.67%, as shown below. The Top 20 Leaders have also outperformed, which has not suited our style bias away from the leaders.

### Australian Equities Performance Total Returns: CYTD to 30 Nov 2022



Source: Factset.

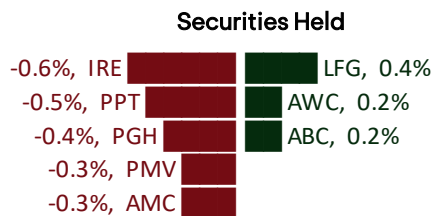
Returns <sup>1</sup> (%)	Gross	Benchmark*	Excess	Net Return
<b>1 Month</b>	4.37	6.58	-2.21	4.31
<b>FYTD</b>	7.59	13.46	-5.87	7.24
<b>CYTD</b>	1.54	2.20	-0.66	0.28
<b>1 Year</b>	4.58	5.00	-0.42	3.21
<b>2 Years (p.a.)</b>	11.78	10.12	1.66	10.54
<b>3 Years (p.a.)</b>	8.02	5.93	2.10	6.88
<b>Since Inception (p.a.)</b>	10.56	8.07	2.49	9.37

<sup>1</sup> 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 November Attribution



**Securities Underweight/Not Held**



Source: Ellerston Capital.

For the month, the main positive contributors were active overweight positions in: Liberty Financial Group (LFG +16.3%), Alumina (AWC +12.2%), Adbri (ABC +9.2%) and zero holdings in the major banks, namely National Australia Bank (NAB -0.2%), Commonwealth Bank (CBA +3.0%) ANZ Bank (ANZ -0.3%) and also James Hardie Industries (JHX -14.1%). However, these positive drivers were not enough to offset the below factors.

The main detractors to performance for the month were overweight positions in: IRESS (IRE -6.3%), Perpetual (PPT +0.4%), Pact Group (PGH -26.1%), Premier Investments (PMV +1.4%), Amcor (AMC +0.4%), as well as not holding Top 20 exceptionally strong performers such as Fortescue Metals (FMG +31.8%) and Rio Tinto (RIO +24.3%). We had a zero weight in Origin Energy which received a \$9.00 cash takeover offer (ORG +41.1%).

## FUND ACTIVITY

The Fund took profits in IRESS, Premier Investments and Woodside Energy given recent share price moves. We exited the remnant positions in Adbri, Ansell, EQT Holdings and Transurban Group. The proceeds were used to top up CSR and add three new stocks to the portfolio; Perpetual, QBE Insurance Group and Santos, see write-ups below.

NEW STOCKS ADDED	STOCKS EXITED
<ul style="list-style-type: none"> <li>• Perpetual</li> <li>• QBE Insurance Group</li> <li>• Santos</li> </ul>	<ul style="list-style-type: none"> <li>• Adbri</li> <li>• Ansell</li> <li>• EQT Holdings</li> <li>• Transurban Group</li> </ul>
INCREASED	DECREASED
<ul style="list-style-type: none"> <li>• CSR</li> </ul>	<ul style="list-style-type: none"> <li>• IRESS</li> <li>• Premier Investments</li> <li>• Woodside Energy</li> </ul>

We introduced **Perpetual (PPT)** to the fund on November 17<sup>th</sup> after the shares fell sharply, following their announced amended deal terms with Pandal group (PDL) and simultaneous critical court decision. The new terms effectively means more issuance of equity (3.7m extra shares = +3.3% on the combined converted share-count) and less cash being paid to PDL shareholders (thus less leverage). At the same time, the Supreme Court of NSW clarified that PPT could not limit potential damages at \$23m to PDL by walking away from the Scheme Implementation. This judgement increases the likelihood of a deal completion by lowering the risk of PPT accepting another offer (Regal/BPEA's revised \$33.00 cash offer following the Consortium's initial offer of \$30.00 cash) with limited downside. Given this finding, it would appear in the eyes of the market that the takeover prospects for PPT have faded.

Deal update : PPT and PDL announced a mutually agreed amended cash and scrip mix for the scheme under which PDL shareholders will now receive (a) 1 PPT share in exchange for 7 PDL shares (earlier 7.5) + \$1.65 cash (earlier \$1.976) per PDL share. The amended scheme has the same offer price based on PPT's undisturbed share price of \$34.23 as at 1<sup>st</sup> Apr-22. This change lowers the group's leverage as the amended scheme reflects a 16.5% reduction in cash component of ~\$125m.



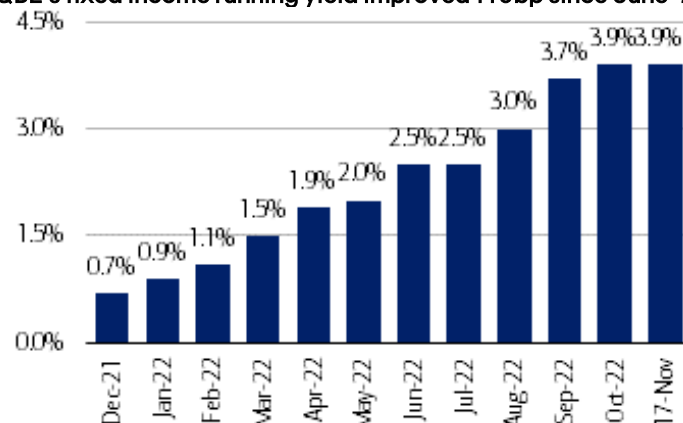
Court Update: The NSW Supreme Court clarified that if PPT did not complete the Scheme due to there being a superior takeover proposal for themselves, damages would not be limited to \$23m and PDL could seek to enforce PPT's obligations to complete the Scheme. The Court approved the convening of the meeting to vote on the Scheme of Arrangement meeting which has been set for 23<sup>rd</sup> December.

On a fundamental standalone basis, we feel there is value in the name and upside to PPT, given strong press speculation that there are multiple buyers interested in their valuable Corporate Trust (PCT, with over A\$1trillion of Funds Under Administration) and Perpetual Private (PP) businesses. It is not hard to value the sum-of-the-parts for PCT and PP at between \$1.4bn to \$1.8bn and given Perpetual's market cap has fallen to just \$1.55bn, leaving an associated value for its Australian and International Funds Management (Barrow Hanley and Trillium ESG) businesses for free, or even negative value. The shares also offer an attractive dividend yield of 6.2% pre franking.

**We have ventured back into QBE Insurance Group ( for the first time in a long while - double-digit insurance margins are still on-track given interest rate leverage and hardening rates, trading on a heavily discounted valuation relative to offshore peers.**

QBE is on-track to deliver double-digit insurance margins in 2H22E for only the second time in six years, with forecast rapidly rising yields set to deliver a stronger contribution to margins. **The 3Q22 exit fixed income running yield was strong at 3.7%** (1H22 exit rate of 2.5% and 3.9% as at 17 Nov), with 3Q22 total investment FUM fairly steady at US\$26.3bn.

**QBE's fixed income running yield improved 140bp since June-22**



Source: B of A Global Research.

Whilst late-in-year trading updates from QBE have historically been unfavourable, its latest update revealed underlying earnings drivers that were tracking in line with our expectations. The 3Q22 trading update was mixed - the company increased FY22 expectations by US\$100m for catastrophes (impacts largely weather related and included US\$75m of Ukraine conflict claims ) and also flagged increased inflation headwinds. On balance, the medium term outlook remains positive as the key driver, being GWP growth, continues to be very solid. GWP growth has modestly slowed, but is still robust at 16% CC on the prior period, ahead of guidance of ~10%. In relation to reserving, QBE commented that they will strengthen reserves further to build resilience for inflationary pressures, however, this would be equally offset by releases from COVID-19 related risk margins (~US\$150m available). Whilst there is always the risk of downgrades to FY23 consensus catastrophe expectations, we believe the stock is trading at a sufficiently large enough discount to global peers to warrant our investment.

**Q322 Update: GWP and pricing momentum.**

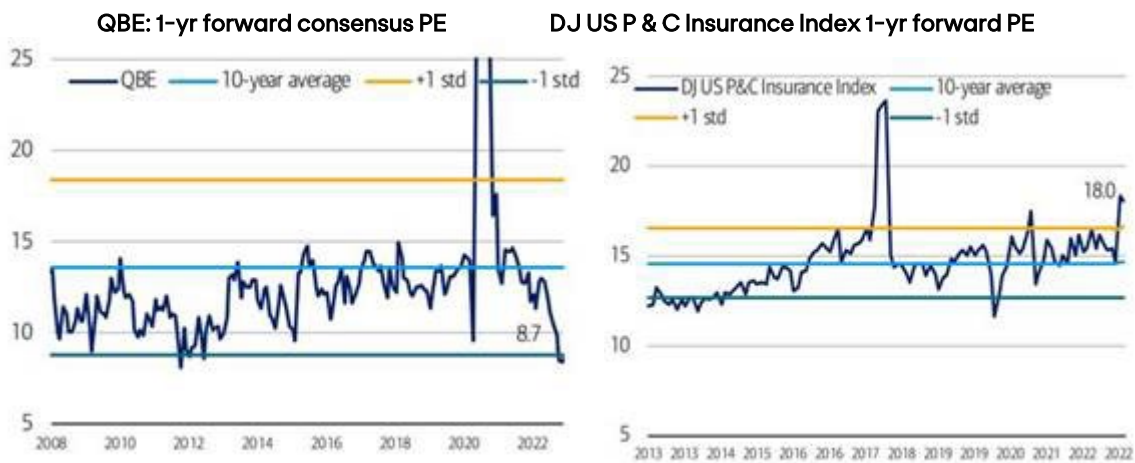
- Year to September GWP growth was +12% vs pcp +16% Constant Currency (CC), with ex-rate growth of 11%.
- GWP growth remained strong in 3Q22, +6% on pcp +13% (CC).
- Excl. Crop, Group GWP growth +12% in CC, with ex-rate growth of 6%.
- Group-wide renewal rate increases averaged 8.4% in 3Q22.
- 3Q22 rate increase: NA +9.1%, International +6.3%, APAC +9.4%.

**FY22 Guidance:** QBE expect Group CC GWP Growth of ~10% (unchanged), and a Group COR of ~94% (Visible Alpha consensus was 93.6%) vs previous expectations of low to mid 90s. QBE has targeted "consistent low to mid 90s COR through-cycle".

**Valuation:** QBE trades at 8x FY23E P/E, vs its 14x 10-year average forward consensus P/E.

QBE's 1-year forward consensus P/E has de-rated ~30% calendar year-to-date, significantly underperforming its US peers , with US comps re-rating by +12%!

**At 8.0x P/E and 1.3x P/B (based on FY23 estimates), QBE screens attractively relative to global peer average on 11.9x and 1.9x P/BV.**



Source B of A Global Research.

**Conclusion:** We make the observation that the softer Q322 update was mostly of a 'one-off' (no pun intended for QBE, a repeat offender of one offs) relating to weather related catastrophe claims and a challenging crop year in North America (drought, damage from Hurricane Ian). Claims inflation concerns have held the stock back, however inflation headwinds are mostly balanced and should be offset in FY23E by ongoing premium rate momentum. The US\$ appreciation has benefited QBE's earnings upon translation to A\$, with US\$ exposures representing ~57% of GWP and 33% of investments. **The ongoing core re-insurance business still appears sound and together with investment yields marching higher, combined with a 6.0% dividend yield, we have become more positive on the prospects for QBE for the first time in a long time. A re-rating to 11x (still a discount to peers) as the market becomes more comfortable with the company's ability to achieve higher ROEs, drives a target price of ~\$17.00.**

**Santos (STO)** has been a huge laggard this CYTD, significantly underperforming its global oil and gas peers - especially its major domestic peer, Woodside Energy, by over 50%. Its share price is currently back to where it was 22 months ago, when oil was US\$52/bbl, and prior to the highly accretive Oil Search transaction which was completed in December 2021. STO has been weighed down by post-deal indigestion, poor messaging around their Pikka Alaska oil project's final investment decision and/or sell-down and its recently announced disappointing CY23 production guidance, which came in 8% below consensus. Lower expected capital returns compared to peers, given the capex requirements for both its Pikka and the Barossa LNG projects, which kick in from 2025 onwards, hasn't helped sentiment either. STO is currently appealing the original verdict on Barossa LNG that ruled the Drilling Environmental Plan for the Barossa project to be invalid. By way of background, STO has a 50% interest and is the operator of the US\$3.6bn LNG project off Northern Australia. Development drilling at Barossa was actually suspended back in August 2022 in the lead-up to the verdict of the original case and most analysts have already factored in a slight delay. The Full Bench of the Federal Court will decide soon, but we don't believe whether STO win the appeal or not, that a potential delay will have any material cost or schedule impact on the project for first gas delivery in 2025. STO will merely submit a new and revised environmental drilling plan.

Successful sell-downs of STO's interests in both PNG LNG and Pikka projects should see significant capital management from current levels - when executed. The current 5% sale to PNG's national oil and gas company, Kumul Petroleum, for US\$1.4bn would result in US\$400-\$500m of incremental buybacks to simply bring gearing back towards the bottom end of STO's 15-25% targeted range. A Pikka sell-down of 20% (STO has 51%) would raise US\$0.4-0.5bn and reduce its share of project capex by ~US\$0.5bn, which combined with the PNG LNG sell down would result in collective buybacks of 10% of its shares (more in line with peers' capital management programs). We see Santo's higher shareholder returns focus as a major catalyst and opportune entry point to own this materially undervalued energy company.

## FUND STRATEGY AND OUTLOOK

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

The US FOMC committee minutes were released which stated a "substantial majority of participants judged that a slowing in the pace of increase would likely soon be appropriate. A slower pace in these circumstances would better allow the Committee to assess progress toward its goals of maximum employment and price stability." Later at a Brookings Institute presentation, Fed Chair Powell commented that "it makes sense to moderate the pace of our rate increases as we approach the level of restraint that will be sufficient to bring inflation down". He added "the time for moderating the pace of rate increases may come as soon as the December meeting." As a consequence, the market is now pricing in a smaller 50bps rise at the December FOMC meeting.

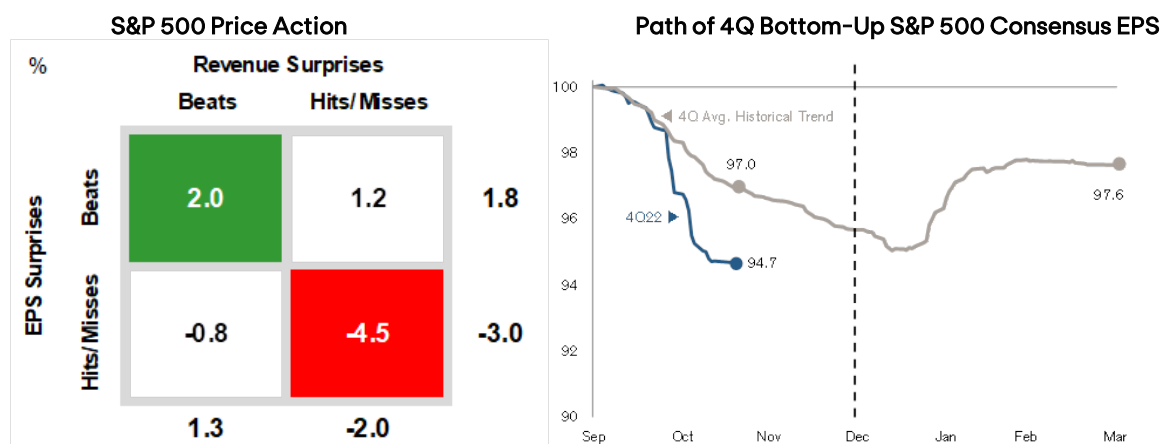
As expected, equity and bond markets reacted positively. However, despite nearing the peak in the interest rate cycle we are not there yet, nor do we have a handle on its duration. At the aforementioned presentation, Powell said "given our progress in tightening policy, the timing of that moderation is far less significant than the questions of how much further we will need to raise rates to control inflation, and the length of time it will be necessary to hold policy at a restrictive level". Having been previously 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 again, all about not fighting the Fed! The RBA too will need to raise rates, but the size of expected hikes have moderated.

Whilst we have seen large moves in the more "speculative" areas of the equity market, it's very doubtful that it will be BAU going forward. Many of the "bubbles" that persisted during the era of zero rates have now proven to be transitory and have been pricked.

The crypto ecosystem encountered rapid deleveraging during the month in the fallout from the crisis that hit digital-asset exchange FTX.com. Fallen from grace 30 year old crypto mogul Sam Bankman-Fried was forced to shut down his Alameda Research unit, the trading house at the heart of his digital-asset empire, in a futile attempt to save his troubled crypto exchange FTX.com. Bankman-Fried's hastily-agreed rescue by rival Binance Holdings Ltd. completely fell apart, with US regulators probing FTX's dealings and a prominent investor writing down its stake in the company to zero. Alameda Research was a crucial part of his crypto empire, although questions around its balance sheet had been swirling following an article by prominent CoinDesk earlier in November. The "cascade of margin calls" caused major contagion, pushing Bitcoin down to an intra-month low of US\$16,000. Strategists pointed to Bitcoin's production cost as a way of calibrating how much further it can potentially fall. The production cost which stands at ~\$15,000, is predominantly the electricity needed to operate computers that run the Bitcoin network. The sector will no doubt stay volatile, but one thing is for sure, billions upon billions of crypto dollars were transferred and have gone missing, as regulators try to piece together the FTX imbroglio.

### The month also featured earnings updates with the key takeaways from US 3Q22 Reporting Season below

- Earnings have surpassed estimates by 2.5%, with 64% of companies topping projections.
- Energy was a standout on EPS growth and revenue surprise, 141% and 11.2% respectively.
- TECH+ was a big disappointment, with EPS contracting sharply -6.4%, on a paltry 1.2% surprise.
- Companies beating on both revenues and EPS are generally outperforming the market by +2.0% vs. an average of +1.8%, while stocks missing on both are underperforming by -4.5% vs. -3.0%.
- 4Q consensus EPS forecasts werelowered 5.3%



Source: Credit Suisse.

- Margins came under increased pressure, with only 4.3% EPS growth on 11.0% revenues.
- Value is delivering stronger revenue and EPS growth (11.7% and 7.8%) than Growth (9.3% and -1.1%) in 3Q. Value results are topping estimates by 2.9% vs. 1.9% for Growth.
- More globally-oriented S&P 500 companies are delivering faster EPS growth than their more domestically-oriented peers: 10.7% vs. 5.8%.
- 3 noteworthy bellwether companies that most recently reported and beat estimates were:
  - **Home Depot:** Exceeded forecasts on stronger than expected same store sales and a pickup in average ticket prices. HD reaffirmed its FY 22 guidance.
  - **Cisco Systems:** Topped estimates and boosted its full year revenue forecast on higher networking equipment sales and recurring subscriptions.
  - **Lowe's Cos:** Surpassed consensus on better than forecasted same store sales, stronger pro sales and higher margins. LOW raised its full year profit outlook.

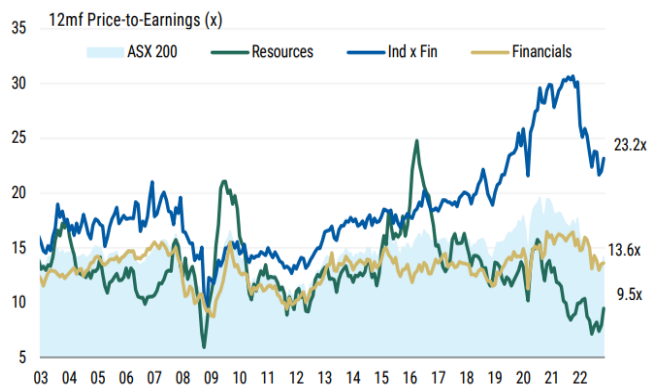
### 3Q22 Earnings Dashboard – S&P 500

	Weighted Growth YoY (%)				EPS
	Revenue	Margins	Earnings	Buybacks	
S&P 500	11.0	-8.6	2.5	1.9	4.3
S&P 500 ex-Boeing	11.1	-7.9	3.2	1.9	5.0
<b>Cyclicals</b>					
Energy	48.3	88.5	136.7	4.5	141.3
Materials	5.8	-18.4	-12.6	3.8	-8.8
Industrials	12.4	3.8	16.2	3.1	19.3
Discretionary	14.2	-6.7	7.5	5.2	12.7
Internet Retail	14.2	-52.1	-37.9	0.8	-37.1
Disc ex-Int Retail	14.2	-1.5	12.7	5.9	18.6
Technology	5.8	-8.9	-3.1	1.5	-1.6
Comm Svcs	1.5	-26.4	-24.9	0.3	-24.6
<b>Non-Cyclicals</b>					
Staples	8.1	-7.6	0.5	0.5	1.0
Health Care	5.5	-6.9	-1.3	1.4	0.1
Utilities	18.0	-28.1	-10.2	-0.1	-10.3
REITs	12.8	3.2	16.0	-4.9	11.1
<b>Cyclicals</b>	20.7	14.7	35.4	4.2	39.7
Cyclicals ex-Energy	12.2	-6.7	5.5	3.7	9.1
Non-Cyclicals	6.3	-8.2	-1.9	0.4	-1.5
TECH+	6.7	-14.6	-7.9	1.5	-6.4
Financials	4.6	-23.2	-18.6	2.4	-16.2
S&P 500 ex-Energy	7.8	-13.0	-5.2	1.7	-3.5
S&P 500 ex-Cyclicals	6.1	-13.9	-7.8	1.3	-6.5
S&P 500 ex-Financials	11.9	-5.0	6.9	1.7	8.5
S&P 500 ex-TECH+	12.0	-5.7	6.3	2.0	8.3

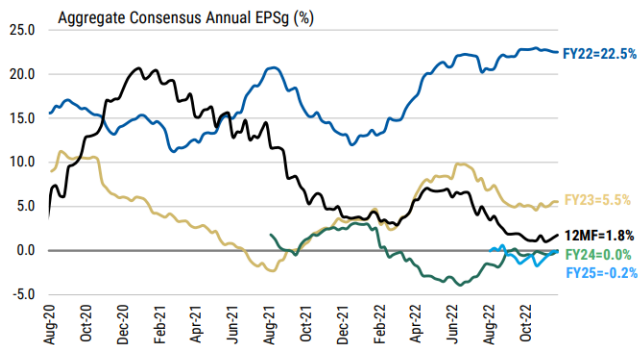
Source: Credit Suisse.

**Valuations:** The domestic market multiples have de-rated meaningfully over the past year but have reversed somewhat in the past few months, with the 12MF P/E now standing at 14.1x. Industrials ex-Financials have compressed to 23.2x 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 9.5x through 2022.

**Valuation: the 12M forward PE of the Industrials ex-Financials has Fallen from 30.2x to 23.2x**



**Annual Consensus EPS Growth Trends FY21-24**



Source: Morgan Stanley Research.

**The investment climate still remains foggy, with all eyes on the Fed's next move.** However the bond market has already experienced a very powerful rally in the past month, with US 10 year treasury yields falling sharply from a 4.15% high, so it's pre-empting a Fed downshift in rates and major contraction in the economy next year. That said, the economic cycle can always be out of sync with the equity market cycle. With the exception of the three new stocks added during the month and some fine-tuning, our strategy remains unchanged.

**Following strong gains in equities over the past two months, we would expect this relief rally to run into resistance at these levels. A pull back in the market would not surprise.**

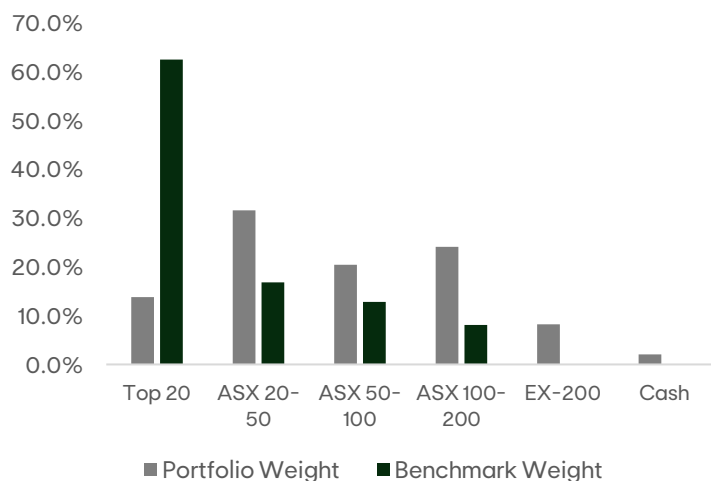
## Portfolio Characteristics

FY23(E) Key Portfolio Metrics	Fund	Benchmark
Price/Earnings (X)	11.5	14.8
Dividend Yield (%)	6.1	4.3
Grossed Up Dividend Yield (%)	7.7	5.8
Dividend Growth Rate (%)	-0.5	0.3
Beta	0.87	1.00

## TOP 10 HOLDINGS

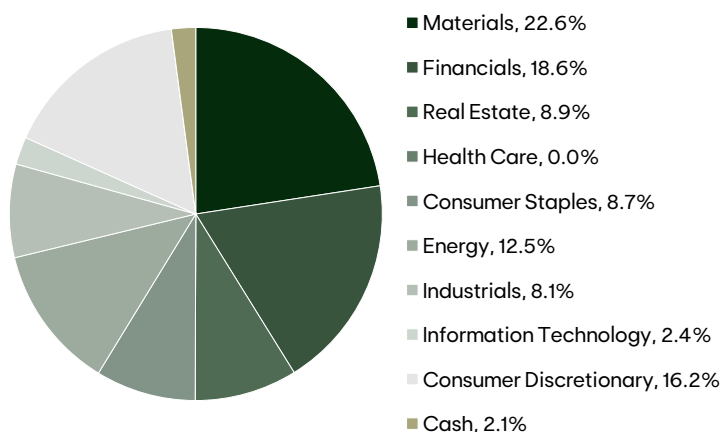
GPT GROUP	8.8%
AMCOR	7.4%
HARVEY NORMAN	7.3%
BHP GROUP	6.8%
CSR	6.1%
TREASURY WINES	5.0%
AMPOL	4.9%
QBE INSURANCE	4.8%
PERPETUAL	4.8%
LIBERTY FINANCIAL GROUP	4.6%

## MARKET CAPITALISATION



Source: Ellerston Capital.

## SECTOR ALLOCATION



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on **1300 101 595** or [Ellerstonfunds@automicgroup.com.au](mailto:Ellerstonfunds@automicgroup.com.au)

Should investors have any questions or queries regarding the Fund, please contact our Investor Relations team on **02 9021 7701** or [info@ellerstoncapital.com](mailto:info@ellerstoncapital.com) or visit us at [ellerstoncapital.com](http://ellerstoncapital.com)

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