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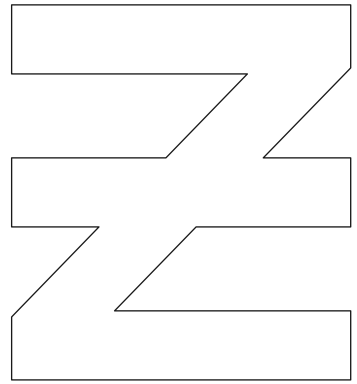


Ellerston Equity Income KIS Fund

Monthly Newsletter, January 2023

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	$1.0843
Net Asset Value	$1.0816
Redemption Price	$1.0789
Liquidity	Daily
No Stocks	33
Strategy FUM	$33.0m
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

FY23(E) Key Portfolio Metrics	Fund	Benchmark
Grossed Up Dividend Yield (%)	7.4%	5.6%
Price/Earnings (X)	11.4	15.1
Dividend Yield (%)	5.8	4.2
Dividend Growth Rate (%)	3.4	-1.1
Beta	0.86	1.00

PERFORMANCE SUMMARY

Performance (%)	1 Month	3 Months	FYTD	1 Year	2 Years (p.a.)	3 Years (p.a.)	Since Inception (p.a.)^^
Net^	5.42	8.14	11.17	9.48	12.61	6.88	9.99
Benchmark*	6.23	9.59	16.66	12.21	10.82	5.96	8.50
Alpha	-0.81	-1.45	-5.49	-2.73	1.80	0.92	1.49

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

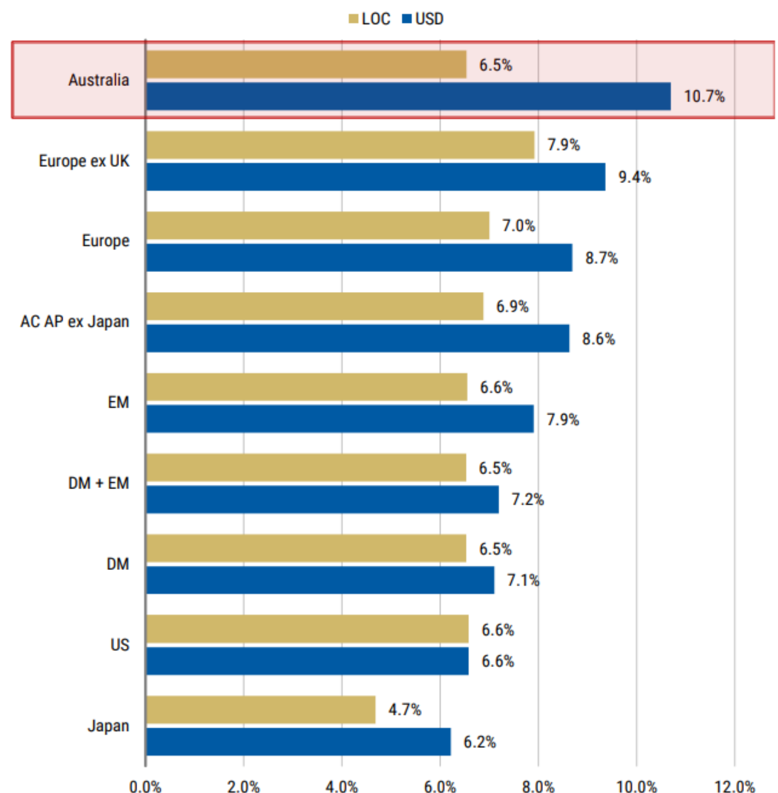
*S&P/ASX 200 Accumulation Index.

MARKET OVERVIEW

Following a torrid year, equity markets surged in January, triggered by the nascent signs of moderating inflation driving a sharp pullback in bond yields and stabilising recessionary expectations. Across the globe, markets squeezed higher, with the MSCI World's 7.1% gain the 2nd best start in well over 30 years. The ASX 200 actually enjoyed its strongest start to a year on record and outperformed the DM World index, with the "dash for trash" in full flight.

Australia starts the 2023 leader board at the top, in US$ terms.

MSCI Global Country/Regional Indices Performance for January 2023



Source: Morgan Stanley.

USA

Economic indicators continued to soften in January, employment data remained elevated and inflationary pressure eased further. The December Core PCE price index, the US Federal Reserve's (Fed) preferred inflation measure, decelerated again from 4.7% to +4.4% YoY from its February peak of 5.4%.

At the time of writing, the Fed as expected, raised its benchmark interest rate by 25bps, to a range of 4.50% to 4.75% and signalled more tightening in 2023. During a post-meeting press conference, Fed Chair Jerome Powell said the FOMC "anticipates that ongoing increases in the target range would be appropriate". The Committee has become more optimistic about inflation and Chair Powell's comments reflected that. He said the disinflationary process has started. However, as Powell emphasised on raising rates, there is "still more work to do", but it will be data dependent.

Following the 19% drop in the S&P 500 Index in calendar 2022, US equities regained credible ground since their October lows. The NASDAQ Composite Index was the outperformer, rising 10.7%, as big tech rebounded strongly, the S&P 500 finished 6.3% higher and the Dow Jones Industrial Average was the laggard, posting a 2.9% return.

US 4Q earnings season summary thus far.

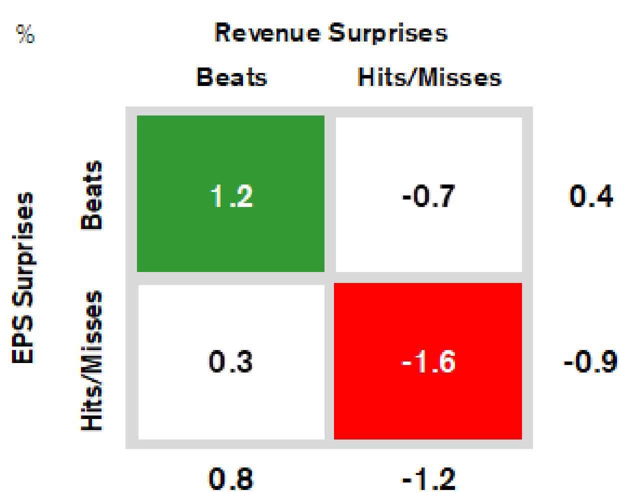
- TECH+ EPS is expected to decline -19.2% in 4Q, versus growth of +6.0% for the rest of the market. Margin contraction is the primary driver of this weakness, subtracting -25.1% for TECH+ and -2.0% for other S&P 500 names. Big Tech: AAPL, GOOGL, AMZN, META and QCOM have all reported. TECH+ results have missed expectations by -1.7% versus +2.9% for the rest of the market.

- 4Q expectations are for revenues and EPS growth of 4.6% and -2.1%. **Ex-TECH+ results appear healthier, with top and bottom-lines expected to jump 5.6% and +6.0%.**

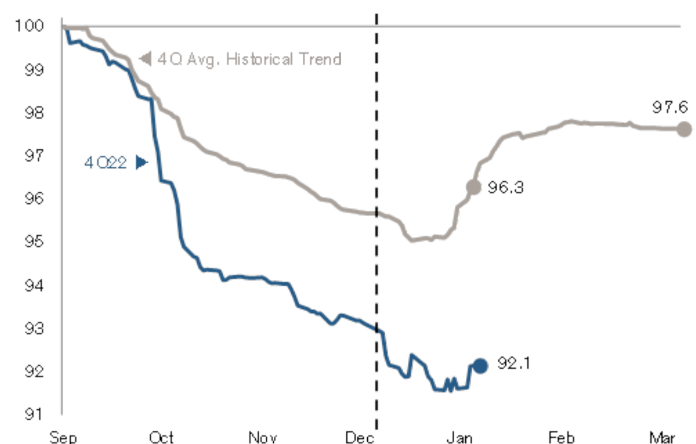
- **68.3% of the S&P 500's market cap has reported. Earnings are beating estimates by +1.5%,** with 63% of companies topping projections. EPS is on pace for -1.6%, assuming the current beat rate of +1.5% for the remainder of this season.

- Companies beating on both revenues and EPS are outperforming the market by +1.2% vs. an average of +1.7%, while ones missing on both are underperforming by -1.6% vs. -3.1%. Social tech company **Meta** (Facebook) was the standout on the upside.
    - **Apple:** Missed expectations on lower iPhone, Mac, and Wearables and accessories results on challenging macro environment and lingering supply snags. AAPL's gross margins came in below consensus.
    - **Alphabet:** Missed estimates on lower advertising revenues, lackluster YouTube performance and lower margins.
    - **Amazon:** Topped revenues as stronger subscription services offset weaker AWS and online sales. Margins came in below consensus.
    - **Eli Lilly:** Surpassed EPS and raised 2023 guidance on stronger pharma sales and margin, however, key drug Mounjaro (diabetes) missed estimates.
    - **Merck:** Topped forecasts on stronger Lagevrio (molnupiravir) sales and stronger margins, but 2023 EPS guidance was below consensus.

S&P500 Price Action



Path of 4Q22 Bottom-Up S&P 500 Consensus EPS



Source: Quantitative Research, Credit Suisse Securities (USA) LLC

Europe

The European Central Bank (ECB) raised rates by 0.5% to 2.5%, signalling that it "intends" to raise rates by another 0.5 per cent at its March meeting, then "evaluate the subsequent path of its monetary policy". Even after a steeper-than-anticipated slowdown in January, euro-zone inflation, at 8.5 per cent, remains more than four times the ECB's 2 per cent target. Not surprisingly, the Bank of England (BoE) also raised rates by 0.5% to 4.0% stating "we have seen a turning of the corner, but it is very early days, and the risks are very large". Governor Bailey said at a press conference after the decision, that it's "too soon to declare victory. Inflationary pressures are still there" and the BoE would have to be "absolutely sure" before shifting its current stance.

The Euro STOXX50 Index finished the month up a sizzling 9.9%. Among the major exchanges, France's CAC 40 was 9.5% higher, Germany's DAX rose 8.7% and UK's FTSE 100 finished 4.3% higher.

Asia

Signs of China's recovery are underway as headline manufacturing PMI rebounded strongly to 50.1 in January from 47.0 in December, reaching expansion territory. The boost from re-opening offset any drag from the Lunar New Year holidays. This ended a three-month run of headline PMI being in contraction territory.

Asian equity markets were also strong, but performance was a mixed bag, with the Hang Seng again being the standout, jumping a staggering 10.4%. Korea's KOSPI rose 8.4%, China's SSE was 6.2% higher, followed by the Nikkei 225 up 4.7% and India's SENSEX was the laggard, down 2.1%, as Gautam Adani's crisis deepened post the reverberations around Short-Seller Hindenburg's report, which undermined broader confidence.

Commodities

Commodity prices were generally stronger, with further China stimulus and abandonment of its Zero-COVID stance driving positive sentiment. Iron ore continued to squeeze higher, with the price up 10% to US$129/tonne. The Brent oil price closed down 2% to at US$84/barrel and natural gas prices weakened, as weather conditions improved in Europe, also dragging thermal coal prices down 35% for the Newcastle benchmark. The base metals complex was much stronger, with the major metals; aluminium up 11%, copper was 10% higher and nickel rose only 1%. Gold was 6% higher at US$1928/ounce, as the US dollar continued to weaken as bond yields retreated.

Bonds

The US 10-year yield fell 36bps to 3.52%, a reaction to stabilising GDP and inflation prints. The Australian 10-year bond yield also retreated, down 50bps to 3.55%, upon slowing rate hikes and stabilising recessionary expectations. This was the sharpest January decline on record.

Australia

As expected, the Reserve Bank of Australia (RBA) delivered another 25bp interest rate increase (the 8th in a row) to 3.10%, with its next meeting scheduled on 7 February. The messaging was clear, the RBA expected more rises in 2023 and the size and timing of future rate increases will continue to be determined by the incoming data and the board's assessment of the outlook for inflation and the labour market.

The A$ closed the month up 4% at US$0.71, with the strong move in iron ore prices and slightly weaker US$.

In the month of January, the S&P/ASX 200 Accumulation Index finished up 6.2%, a record start to the year. This comes on the heels of last year's woeful start, with January 2022's 6.4% pull back the second worst on record. Resources (+7.7%), buffered by higher iron ore and recovering metal prices as China sentiment turned positive, easily outpaced Industrials (+4.8%). The Consumer Discretionary sector (up 9.9%), was the best performer (led by Corporate Travel +24.6%, ARB Corporation +24.0% and Breville Group +23.2%), followed by Materials (+8.9%) and then Real Estate (+8.1%). REIT's enjoyed their best start to the year as a standalone sector. The bottom three sectors were Utilities (-3.0%), Energy (+1.3%) and Healthcare (+3.9%).

For the month, the top stocks that made a positive contribution to the Index's return were BHP Group (+95bps), Commonwealth Bank (+60bps), Macquarie Bank (+35bps), National Australia Bank (+26bps) and Goodman Group (+21bps). Conversely, the bottom five stocks detracting from the Index's performance were Computershare (-7bps), Whitehaven Coal (-5bps), Incitec Pivot (-3bps), Amcor (-3bps) and Origin Energy (-2bps). The ASX Small Ordinaries rose 6.6%, pipping the broader benchmark by 0.4%. Within the ASX Small Ordinaries, the Small Industrials lagged at 6.3%, with completely bombed out Nuix (+42.4), the best performer.

COMPANY SPECIFIC NEWS

The Market Hits

Sayona Mining (SYA +36.8%) / Pilbara Minerals (PLS +26.7%) / Novonix (NVX +23.5%)

Lithium producer PLS, fledging developer SYA and aspiring synthetic graphite producer NVX, all caught the "relief" rally tailwind. This was a combination of January's "risk on" behaviour, propelling the sizzling 41% rebound in Tesla in the US and China's re-opening, driving expectations of stronger EV/battery demand, despite the lithium price actually falling 11% during the month.

Corporate Travel Management (CTD +24.6%)

Travel companies continued to trade on China re-opening and improved cross boarder flight sentiment and news flows, despite corporate travel volumes flirting with pre-COVID levels. Investors' rightly focused on top-line growth and operating leverage amidst rising cost pressures. Companies demonstrating the following attributes should be better placed to deliver earnings growth and rewarded by the market: 1) secular tailwind from tech investments, 2) continued market share gains, 3) ability to pass on cost rises and deliver operating leverage, and 4) have strong balance sheets to reap the benefit of potential consolidation opportunities - the market believes that CTD meets most of these criteria. Along with peer bookings and travel management service players like Webjet and SiteMinder, the sector enjoyed a powerful rally.

ARB Corporation (ARB +24.0%)

ARB is Australia's largest manufacturer, distributor and marketer of four-wheel drive vehicle accessories in Australia and over 100 countries worldwide. The company's key products include bull bars, suspension springs and air-locking differentials. There was no specific company news, but the ARB stock price tends to track the major listed global car companies, which delivered strong equity returns during the month. Improving supply chains, pent up demand for new vehicles, plus optimism of a recovering global economic outlook given China's re-opening and central banks tapering of rate hikes fuelled the rally.

Breville Group (BRG +23.2%)

Small electrical appliances company BRG rode the wave of strong December retail sales announced in early January by JB Hi-Fi and Super Retail Group, which fired up the whole sector, proving that consumers were still running on the treadmill and spending despite higher interest rates.

Block Inc. (SQ2 +23.0%)

SQ2 performed similarly to peer BNPL names such as Affirm (+67%), ZIP (+28%) and Latitude (+11%) which experienced, what some would call, a "dead cat bounce", after a dismal showing in CY22. In a month where equity markets embraced risk, these bombed out fintech names finally showed signs of life. For the record, SQ2 (formerly known as Afterpay) was down 48% in calendar 2022.

Paladin Energy (PDN +21.4%)

PDN reported that it is on track to re-start its idled Langer Heinrich uranium mine in Namibia in 1QCY24. The company also commented that it has successfully executed three uranium offtake agreements with the previously announced tender awards with US and European counterparties (2 of 3 currently approved). PDN also stated that it secured additional offtakes with China National Nuclear Corp for up to 3.4mlb of U3O8 to be supplied over 2024 and 2025, at market-related pricing. Investors took these updates positively, pushing the stock price back above its April $200m capital raising level of $0.73 per share.

Blackmores (BKL +21.4%)

China re-opening and continued success in its PAWS pet wellness brand helped boost leading vitamin and minerals supplement manufacturer Blackmores shares. Fuelling the fire, it was also revealed in the media that a few months back, it is understood that Blackmores went through a strenuous round of talks with a Japanese strategic player, keen to gobble up the group and take it off the ASX-boards. The Japanese player apparently wasn't the only suitor on the scene, with private equity groups in the region keeping an open file on Blackmores, looking for Australian ways to again play the Chinese consumer boom from a few years back. It is speculated that recent board and management instability at the company may potentially play into their hands.

Pro Medicus (PME +21.0%)

Developer and supplier of healthcare imaging software, PME announced the third contract win in the past two months and the fifth major Integrated Delivery Network group in the last year. Contract wins were ahead of sell-side estimates and helping to propel the share price +58% for the FYTD, despite PME now trading at a mind snapping PE of over 100 times!

The Market Misses

BrainChip Holdings (BRN -15.4%)

BRN, a provider of ultralow power, high-performance AI processor technology, undertook another capital raising via its arrangement with LDA Capital that enables BRN to sell shares at an 8.5% discount, effectively diluting existing shareholders. The recent quarterly update highlighted that BRN was generating little by way of cash receipts and was burning through its funds at a rapid rate. This means that additional funds will be required to keep the business operating. As a rule, investors don't like being diluted.

Whitehaven Coal (WHC -10.8%) / New Hope Corporation (NHC -7.9%)

Both of these leading thermal coal producers were negatively impacted by the 35% fall in the Newcastle benchmark spot price during the month due to warmer northern hemisphere weather.

Computershare (CPU -9.4%)

CPU shares closed lower during the month as investors took the view that higher rates and deposit betas mean that the company's FY23 margin income guidance could be at a peak. Spot & forward rates are now indicating that CPU's margin yield will begin to cool in FY24. Whilst fixed income markets are implying that average cash rates will be modestly lower in FY23 than when guidance was provided at the AGM update (Nov 2022), they are ~40bp lower in FY24 and ~90bp lower in FY25. This should allow CPU to reconfirm FY23 guidance at the 1H23 result, however, FY24 margin income guidance is at risk of being lowered to ~US$940mn (vs. the current ~US$1,010mn). On top of that, several medium-term challenges remain for the underlying business. While CPU's operating model is deliberately set up to diversify earnings from margin income and some counter-cyclical revenues, there is a risk that a recovery in the underlying business may not make up for a lower margin yield. Concerns revolve around mortgage originations, which are still at multi-decade lows and expected to trend lower over 2023 and 2024. Corporate activity also continues to be very subdued at this juncture, amidst a number of uncertainties currently facing the market.

Incitec Pivot (IPL -8.5%)

IPL, a global fertiliser and explosives manufacturer, was impacted by the sudden drop in fertilizer (namely DAP) prices, which continued to fall in January, after peaking at twice current pricing at the start of the war in the Ukraine.

Megaport (MP1 -8.4%)

MP1's share price was smashed on the last day of the month (plunging 26%) post the release of its 2Q metrics, which were weaker than expected across all services. Customer adds (a key lead indicator) were very underwhelming and the key question for investors is whether the recent sluggishness was driven by the macro headwinds or other drivers. While MP1 flagged stable churn, enterprise sales cycles had lengthened, which affected gross-adds in Q2. Customer growth of 39 q/q compared to 90-100 q/q run-rate over FY21/22 and were down from 57 in 1Q23. This was in fact the weakest customer adds reported since FY16. More worrying, the 39 customer adds figure included 12 partners from the PartnerVantage program, so the direct customer adds were even worse. This weakness is likely to continue in 3Q, given recent management commentary on cost optimisation and that their go-to-market review is only expected to deliver results in FY24. While port net adds did improve on a q/q basis, port additions of only 203 in 2Q (incl. the port consolidation impact of 165) was lower than VisibleAlpha consensus estimates of 636 net adds. With the board/management looking at another operational and go-to-market review, investors were left scratching their heads.

Imugene (IMU -6.9%)

IMU is a clinical-stage immune-oncology company focusing on developing a range of immunotherapies to treat and eradicate tumours across various cancer indications. IMU's stock price continued to drift lower (after being down 64% in CY22), with little positive news to get investors excited.

Johns Lyng Group (JLG -5.3%)

With the market having just digested the sizeable surprise COO Lindsay Barber sell down of 4m shares at $6.25 (a 5% discount at the time) to fund his house purchase in Colorado, the optics of "insider" selling of stock just 10 days before going into blackout was concerning. The mere reiteration of FY23 guidance (sales revenue of $1,030.9m and EBITDA of $105.3m) may also disappoint the bulls. The stock fell 12% on the day as a result. That said, there seems little reason to believe that operating conditions have worsened since the AGM, where management commentary indicated that the business continued to track strongly, noting the pipeline of work in Insurance Building & Restoration Services at record levels, driven by BAU opportunities and the well-documented series of CAT's in the media.

Beach Energy (BPT -5.3%)

BPT was weaker on the back of lower oil prices in January, with Brent down 2% (down 5% in Australian dollars), underperforming its listed peers, which have lower oil price sensitivity. Production issues also plagued the stock.

Challenger (CGF -5.2%)

Despite the higher interest rate environment likely to improve the outlook for Challenger's retail sales, market concern centred on maturities, which are also elevated, given that CGF's book continues to contain a significant amount of short-dated annuities. There is also upward pressure on costs and negative mark to market downside risk. With spreads widening, some pressure on property values, coupled with negative returns for alternatives and equity marking to market for 2Q23, certain sell side analysts cut their earnings expectations and lowered their recommendations. Investors were also worried that the capital position could be weaker than originally expected, thus limiting organic growth opportunities. Further market volatility would exacerbate these concerns. The shares closed down 5.2% and underperformed other financials.

FUND PERFORMANCE

The ASX 200 enjoyed its strongest start to a year on record, delivering a return of +6.2%, with many bearish observers labelling it the "junk relief rally'', or "dash for trash", whereby a number of the "dogs" of calendar 2022 have staged a V-shaped recovery. **The Fund's more defensive stance and laser focus on the future potential income streams of our stocks meant the strategy did well to broadly keep pace in a rallying market, returning 5.5%.**

This brings the return for the FYTD to 11.7% pre-gross up for franking credits.

Materials, which rose 8.9%, posted the largest contribution to the market's return in January. For a change, Small Cap stocks (as per their global and US Russell 2000 counterparts) narrowly outperformed this month relative to their Large Cap peers and both Value or Growth as a style, evenly contributed to returns. Consumer Discretionary was the best performing sector (led by Corporate Travel +24.6%), followed by Materials (Sayona Mining, +36.8%) and Real Estate (Goodman Group +15.0%).

Rallying Tech names such as Block (SQ2) and Wisetech (WTC) also featured prominently. Healthcare and Energy were two of the three weakest performing sectors, with Utilities closing down 3.0%, faring the worst (namely AGL down 5.2%).

Returns[1] (%)	*Gross*	*Benchmark**	*Excess*	*Net Return*
1 Month	5.48	6.23	-0.75	5.42
3 Months	8.32	9.59	-1.26	8.14
FYTD	11.67	16.66	-4.99	11.17
1 Year	10.70	12.21	-1.50	9.48
2 Years (p.a.)	13.87	10.82	3.05	12.61
3 Years (p.a.)	8.04	5.96	2.08	6.88
Since Inception (p.a.)	11.16	8.50	2.66	9.99

[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 January Attribution

Securities Held

-0.3%, LFG-AU | RWC-AU, 0.3%
-0.3%, AMC-AU | BKL-AU, 0.3%
-0.3%, IGO-AU | CSR-AU, 0.3%
-0.3%, STO-AU | PMV-AU, 0.2%

Securities Underweight/Not Held

-0.2%, MQG-AU | WBC-AU, 0.2%
CSL-AU, 0.2%

Source: Ellerston Capital.

In January, the main positive contributors were active overweight positions in Reliance Worldwide (RWC +16.2%), the recent addition of Blackmores (BKL +17.0%), CSR (CSR +11.5%), Premier Investments (PMV +15.1%) and zero holdings in Westpac (WBC +1.6%) and CSL (CSL +3.6%).

The main detractors for the month were overweights in Liberty Financial (LFG -0.9%), Amcor (AMC -4.7%), IGO (IGO -5.4%) and Santos (STO -0.8%), coupled with a zero holding in Macquarie Bank (MQG +12.2%).

FUND ACTIVITY

The Fund was highly active during the month, exiting remnant positions in Alumina, Northern Star Resources and Waypoint REIT and taking profits in stocks that have re-bounded sharply off their recent lows, namely Ampol, CSR, Harvey Norman and Reliance Worldwide. The proceeds were re-deployed in four new positions: Blackmores, IGO, Iluka Resources and Smartgroup (see write-ups below). We also strengthened existing holdings in Eagers Automotive and Perpetual on the pull back.

NEW STOCKS ADDED	STOCKS EXITED
• Blackmores	• Alumina
• IGO	• Northern Star Resources
• Iluka	• Waypoint REIT
• Smartgroup	

INCREASED	DECREASED
• Eagers Automotive	• Ampol
• Perpetual	• CSR
	• Harvey Norman
	• Reliance Worldwide

Blackmores (BKL)

BKL is involved in the marketing of vitamins, dietary supplements, nutritional products, and traditional Chinese medicine. It has operations in Australia, New Zealand, China, and South East Asia. We added BKL to the portfolio very early in the month, as a re-opening play. Going forward, we see the company's China sales (22% of group FY22 sales) to benefit from increased demand for immunity-related products (historically ~10% of sales) as China has only recently re-opened amidst the ongoing surge in COVID cases. BKL appears on track to reach its target of $55 million in gross annualized savings, with the final $10 million expected during FY23. Recent mid-to-high single-digit price rises (effective Sept 2022) along with the potential for another round of price increases in 2H23, should offset some inflationary pressures, but the 1H23 may prove challenging. Earnings will recover in FY24 and should return to pre-COVID levels, which is more than two-times FY22 net profit and so will the dividend stream!

IGO Limited (IGO)

IGO's future facing EV commodity portfolio of nickel and lithium, with stakes in the world class Greenbushes spodumene mine (the largest and lowest cost hard rock lithium mine globally) and its lithium hydroxide plant being ramped up at Kwinana, complement a nickel based business with exploration upside. IGO offers more defensive attributes than its listed peers. Despite some short-term obstacles, IGO should generate ~$1.2bn of free cash flow this financial year, after capital expenditure or ~$440m, mainly to bring its Cosmos nickel mine on stream, with FY24 seeing free cash flow at least doubling at current commodity prices. FY23 will see the start of significant increases in fully franked dividend streams for a number of years. IGO trades at an attractive FY24 EV/EBITDA multiple of 6.0x, well below international peers like Albemarle at 8.0x. Furthermore, IGO has the highest dividend yield, given its superior free cash flow generation. We forecast a declining and more conservative lithium price environment, thus we expect IGO's low cost assets (with scale benefits) to outperform its peers on margin, with equity lithium carbonate equivalent (LCE) production growth of 2.3x from Greenbushes and Kwinana over the next 5 years supporting earnings, free cash flow and future dividends.

Not surprisingly, IGO reported weaker 2Q production volumes in its nickel operations impacted by the recent an 18-day fire outage at its Nova mine and higher costs at its Forrestania operation in WA, which will benefit when Cosmos comes on stream. The lithium business, which represents ~85% of IGO's valuation, and the Greenbushes mine performed well. The stumbling block was IGO's investment decision on its second lithium hydroxide plant which was deferred for 6 months, as they ramp up and commission the existing plant and consider the learnings, before committing. This disappointed some sell-side analysts. The stock sold off 7% on the day, despite reporting a record half-year profit result of $591m and increased dividend. We see these as transitory timing issues, which have an impact on immediate earnings, but little on the overall longer-term valuation and have used the weakness in share price as an opportunity to add the stock to the portfolio.

Iluka (ILU)

Mineral sands and future rare earths producer, ILU was added to the portfolio as we gained more confidence in the China re-opening theme, as China is a major importer of mineral sands - particularly zircon (extensively used in the ceramic tile industry). That market has been very soft due to COVID restrictions and weakness in the real estate market - we view the recent removal of strict restrictions to be a positive driver going forward over the medium term. We were also encouraged by the further de-risking of the company's Eneabba rare earths refinery (which reached financial close on the $1.25bn non-recourse loan by the federal government's critical minerals fund under a sharing arrangement) and strong operational performance post the Q4 22 update that has enabled the company to generate very strong cash conversion. We also note that ILU as a major supplier has sold out of zircon in 2022, with inventory at historic lows, so there is no inventory overhang to worry about. ILU's Eneabba rare earths refinery is a strategic asset, considering it will be only the third western world rare earths facility, which will produce 18ktpa of rare earths with 3.5-4ktpa of high value NdPr. The Eneabba Phase 3 fully integrated refinery also improves the economics of ILU's key planned Wimmera deposit in Victoria's Murray Basin, which will produce both mineral sands and rare earths. The company's valuation is highly attractive with ILU trading on just ~5x EV/EBITDA versus key rare earths producers at ~14x and mineral sands industry peers at ~8x. ILU has a pristine balance sheet with $489m of net cash on hand and has a 20% residual strategic holding in Deterra Royalties currently worth $0.5bn.

Smartgroup Corporation (SIQ)

SIQ is a provider of employee benefits and workforce optimization services for public-benevolent-institutions (PBI), government, health, and corporate organisations. Smartgroup also provides fleet management and software services. SIQ was founded in 1999 and since listing on the ASX in 2014, has made 9 acquisitions, which has seen it grow to the number 1 salary packaging provider and number 2 novated leasing provider in Australia. SIQ has been affected by global supply chain issues which have constrained vehicle availability, impacting the conversion into orders and transaction volumes. SIQ should do well as supply channels conitinue to improve, further, it should benefit from the FBT tax breaks for EV's recently legislated by the Federal Government. A novated lease allows an employee to lease a new car for personal use, but pay for the repayments with pre-tax income, hence reducing taxable receipts, as opposed to using finance paid for with after-tax salary. Although the practice does not cost the employer, it does count as a fringe benefit or an in-kind payment to an employee, which incurs fringe benefit tax - but no longer for eligible EVs. After having de-rated to a PE of 11x and a dividend yield of 7%, we added it to the portfolio.

FUND STRATEGY AND OUTLOOK

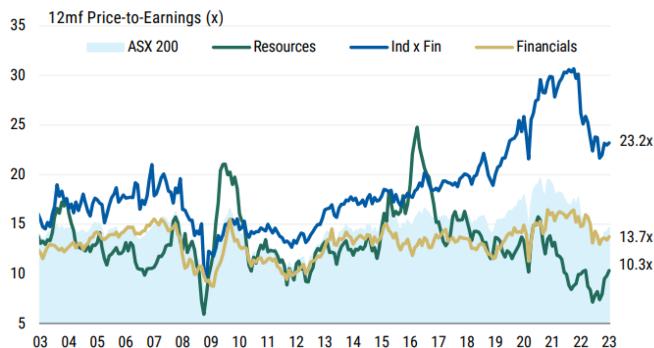
So far, equities have performed broadly in line with our previous expectations - front and centre are of course investors pre-occupation with central bank policy direction. However, concerns about a synchronised global growth slow down and fears of a sharp deceleration in economic activity are fast receding, as are the prospects of an earnings recession in the US given the generally healthy Ex-Tech Q4 reporting season scorecard thus far. Tech + EPS is expected to decline -19.2% in 4Q, vs growth of 6% for the rest of the market. Recent moves by central banks has tempered the mood, but the risks remain. The market is clearly pricing in a "soft-landing".

The Fed has recently become more optimistic regarding inflation and could pause after their March meeting. However, the huge payrolls print for January (+517,000, well above consensus of +188,000) could set the cat amongst the pigeons in the Fed "pivot" debate. The Bank of Canada raised interest rates to 4.5% for an eighth consecutive and potentially final time, saying it expects to move to the sidelines and assess the impact of its rapid tightening on the economy. Norway's central bank, which was ahead of the curve and was one of the first central banks to start its tightening policy, surprised observers and is also on hold and the ECB signalled that a March rate hike might be the last. It's starting to look like RBA Governor Phillip Lowe may go the same way after the next widely anticipated 25bps raise to 3.35% on 7 February.

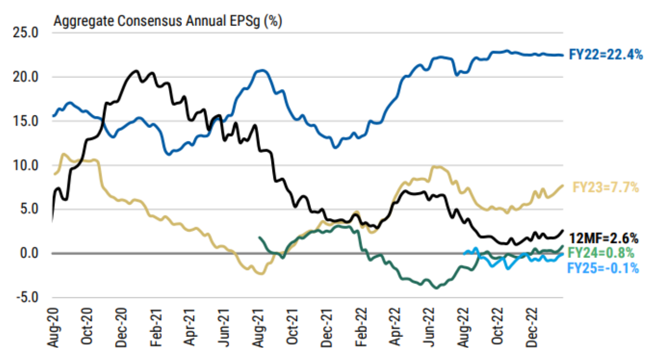
We have lived in a macro market for the last three years, driven by shocks: COVID, the biggest fiscal package ever and an aggressive Central Bank hiking cycle to curb outsized inflation. Now, assuming central banks are successful in taming inflation, micro factors should take over the reins. Sector dynamics, the resurgence of M&A activity and company-specific drivers should play a bigger role in future performance differentiation. Triggers for this shift include increased confidence among investors that we are nearing the end of a hiking cycle, as well as more visibility around the timing and depth of a recession. However, a number of cross currents are likely to complicate 2023, resulting in outcomes not necessarily found in a classic market cycle playbook.

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 14.7x. Outer year earnings growth forecasts are fairly anchored in the low-single-digit territory.

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



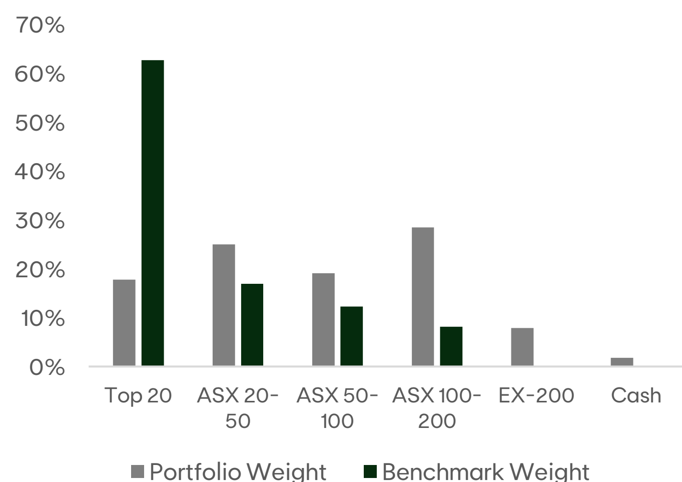
Source: Morgan Stanley Research.

The investment climate still remains clouded, as markets deal with the lagged economic effect of interest rate rises, which we seem to be near the end point and the reticence for easing policy by central banks. Official rates look like they will stay higher for longer! We started reducing our defensive tilt somewhat late last year and accelerated this stance early in the new year. We believe that the earnings risk in a number of sectors has been overdone, now that the probability of a soft landing has increased.

However, following strong gains in equities over the past 4 months, we would expect to run into some resistance, especially as we go into the domestic earnings reporting season. The recent string of disappointing Big Tech shocks by the likes of Amazon, Alphabet, Apple and Atlassian delivered a reminder that tech revenue growth is slowing and profitability is under pressure as consumers and advertisers reduce their spending under the weight of higher interest rates and weaker volumes. There will no doubt be a skew to a "soft first half" and improved outlook for 2H earnings in the outlook commentary, given the macro and stock specific headwinds in various sectors. The more difficult question will be how the market reacts to the messaging by companies. So far, from a macro perspective, the labour market and earnings outlook have been surprisingly resilient.

Post the rally in January, the grossed up dividend yield on the portfolio now rests at 7.4%, which is superior to the market. We remain underweight Tech and the "racier" end of the market, which offer little in the way of dividends.

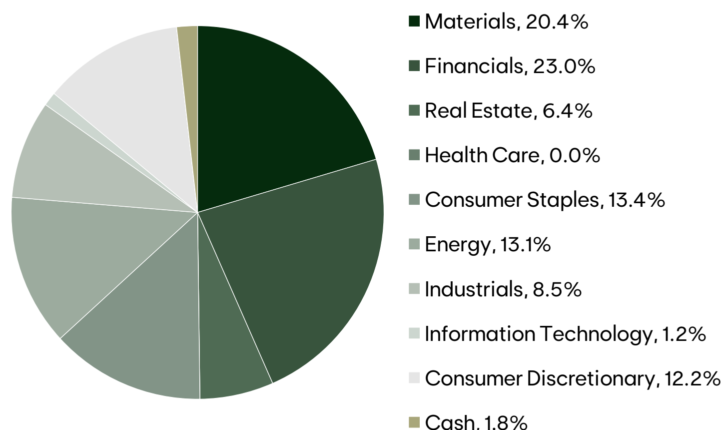
MARKET CAPITALISATION



TOP 10 HOLDINGS

TOP 10 HOLDINGS	
PERPETUAL	8.9%
BHP GROUP	8.9%
QBE INSURANCE GROUP	7.8%
GPT GROUP	6.3%
TREASURY WINES	5.7%
SANTOS	4.8%
IGO	4.4%
HARVEY NORMAN	4.4%
LIBERTY FINANCIAL	4.3%
WOODSIDE ENERGY	4.1%

SECTOR ALLOCATION



Source: Ellerston Capital.

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

The Fund is also available for application through the NetWealth and HUB24 Platforms.

All holding enquiries should be directed to our register, Automic Group on **1300 101 595** or 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 or visit us at ellerstoncapital.com

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