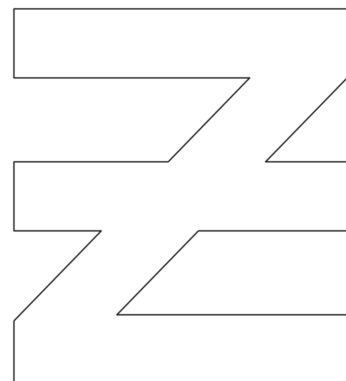


Ellerston Overlay Australian Share Fund (OASF)

Performance Report, January 2023

Investment Objective
The Investment objective for the Ellerston Overlay ASF is to outperform the S&P/ASX 200 Accumulation Index (Benchmark).

Investment Strategy
The Fund uses a benchmark-independent, high conviction approach that looks beyond investing in the Top 20 stocks in order to capture the neglected opportunities created by under-researched stocks in the broader Australian market.

Key Information

Class Inception**	1 July 2011
Portfolio Manager	Chris Kourtis
Application Price	$1.1113
Net Asset Value	$1.1085
Redemption Price	$1.1057
Liquidity	Weekly
No Stocks	22
Management Fee	0.90% p.a.
Performance Fee	15% p.a. of outperformance
Buy/Sell Spread	0.25% on application 0.25% on redemption

Performance Class A (%)	1 Month	3 Months	FYTD	2 Years (p.a.)	3 Years (p.a.)	Since Inception (p.a.)**
Net^	5.59	11.95	12.61	13.86	7.04	7.75
Benchmark*	6.23	9.59	16.66	10.82	5.96	9.06

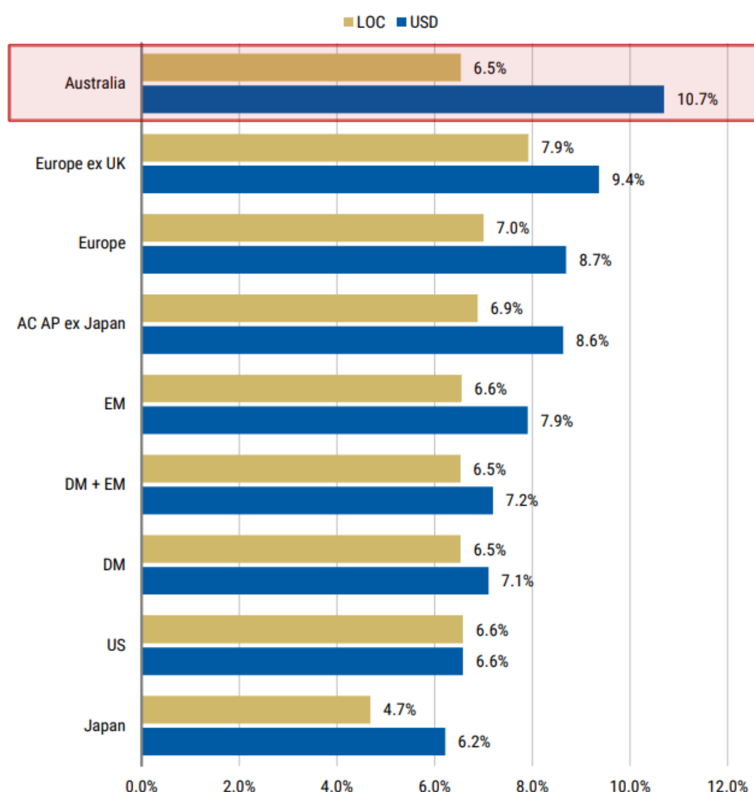
^Net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance.
*The benchmark was changed from the S&P/ASX 200 Accumulation Ex REITS Index to the S&P/ASX 200 Accumulation Index on 1 July 2012

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%.

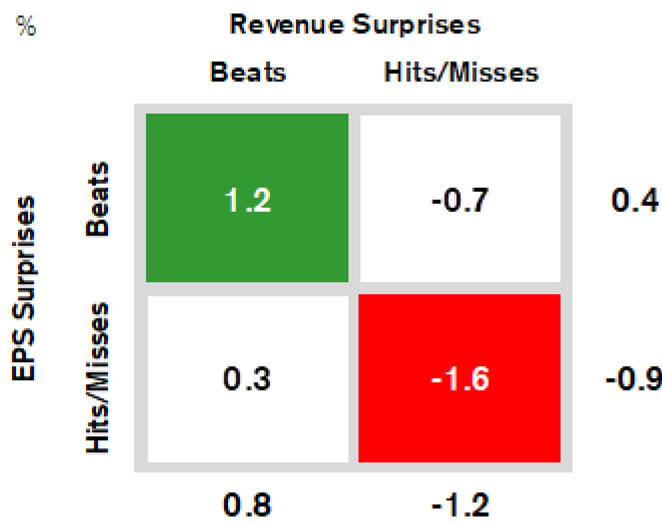
At the time of writing, the Fed as expected, raised its benchmark interest rate by 25bps, to a range of 4.50% to 4.75% and signalled more tightening in 2023. During a post-meeting press conference, Fed Chair Jerome Powell said the FOMC "anticipates that ongoing increases in the target range would be 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 meant the strategy did well to broadly keep pace with the market, returning 5.7%.

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%).

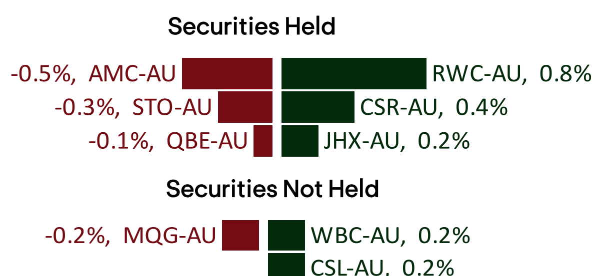
Returns^ (%)	*Gross*	*Benchmark**	*Excess*	*Net*
1 Month	5.67	6.23	-0.56	5.59
3 Months	12.19	9.59	2.60	11.95
FYTD	13.21	16.66	-3.44	12.61
1 Year	5.85	12.21	-6.36	4.83
2 Years (p.a.)	15.03	10.82	4.21	13.86
3 Years (p.a.)	8.18	5.96	2.21	7.04
10 Years (p.a.)	8.51	8.79	-0.28	7.44
*Since inception (p.a.)***	8.88	9.06	-0.18	7.75

^The return figures are calculated using the redemption price for Class A Units and are and are net of fees and expenses. Returns are also calculated on the basis that distributions are reinvested. 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.

** Since Inception is 1 July 2011.

Month of January Attribution



Source: Ellerston Capital.

In January, the main positive contributors were active overweight positions in Reliance Worldwide (RWC +18.6%), CSR (CSR +11.7%), James Hardie Industries (JHX +19.1%) and zero holdings in Westpac (WBC +1.6%) and CSL (CSL +3.6%).

The main detractors for the month were overweights in Amcor (AMC -5.1%), Santos (STO -0.4%) and QBE Insurance (QBE +2.3%), coupled with a zero holding in Macquarie Bank (MQG +12.2%).

FUND ACTIVITY

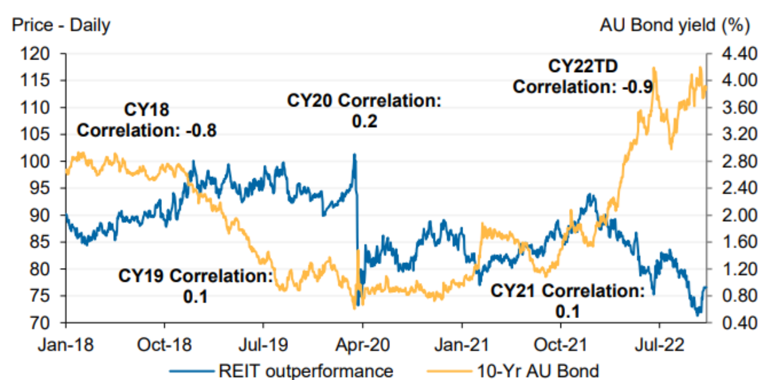
The Fund was highly active during the month, exiting remnant positions in Alumina and The Lottery Corporation and taking profits in stocks that have re-bounded sharply off their recent lows, namely Ampol, Bega Cheese, CSR, Iress, Harvey Norman and Reliance Worldwide. The proceeds were re-deployed in four new positions: GPT Group, IGO, Iluka Resources and James Hardie Industries (see write-ups below). We also strengthened existing holdings in Amcor and Santos on the pull back.

NEW STOCKS ADDED	STOCKS EXITED
• GPT Group	• Alumina
• IGO	• The Lottery Corporation
• Iluka Resources	
• James Hardie Industries	

INCREASED	DECREASED
• Amcor	• Ampol
• Santos	• Bega Cheese
	• CSR
	• Iress
	• Harvey Norman
	• Reliance Worldwide Corporation

We added some interest rate sensitivity to the portfolio, as we felt that yields at the long end of the curve may have peaked and introduced bombed out GPT at the very start of the month for the first time since inception. GPT is a diversified (~Retail 35%, Office 37% and Industrial 28%) REIT and post some recent asset sales, has strengthened its balance sheet (gearing now sits at 29%). GPT trades at a ~30% discount to NTA and the sector has massively underperformed the ASX200 Accumulation Index by 20% in 2022, as bond yields spiked, but now look like they may have seen their best. In 2022, an underwhelming "return" to CBD globally saw office REIT's in particular underperform and this has been the main concern for GPT's exposure to the space. With GPT trading at historically cheap levels of discount to NTA, value has finally emerged. GPT has a distribution yield of 6% (unfranked) and we believe the market is not factoring in the value of their Funds management business, which has grown to over $17bn in AUM and is worth ~$0.30/share (7%). Our conservative Net Asset Value sees 20%+ upside from the current share price.

Negative correlation with bond yields has led to REIT underperformance in 2022



Source: Macquarie

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, is more defensive 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 ~85-90% of IGO's valuation, and the Greenbushes mine performed well. The stumbling block was that 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, which disappointed some sell-side analysts. The stock sold off 7% 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.

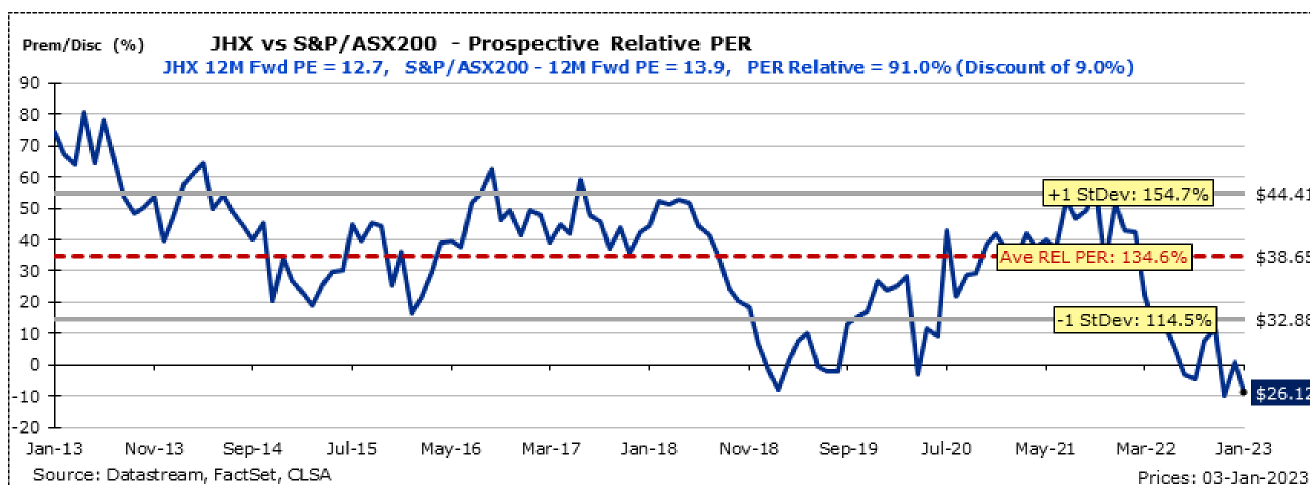
James Hardie Industries (JHX)

We started exiting the Fund's JHX position back early August 2022 at lofty levels through to mid-September, at what proved to be very attractive prices, based on our concerns that higher mortgage interest rates in the US would negatively impact the housing market and well prior the company delivering a massive downgrade.

Very well held market darling JHX subsequently sold off sharply on the 8th of November following a much 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 business segments. JHX downgraded 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 a US$200m share buyback program in place of the dividend, equivalent to ~2% of its market cap. With housing conditions deteriorating further in the US and new industry capacity coming online, the headwinds were building, but prior to the update, were not priced in.

A sharp deterioration in new home starts a few months after we exited the stock led JHX to update the market, with management anticipating 2HFY23 new construction volumes to fall by 30%. Renovation and repair (R&R) was expected to remain more resilient, with JHX guiding to flattish growth in 2HFY23, leading to a 5-8% overall volume decline. The stock traded ~6% worse than the downgrade on that day, the abrupt change in the outlook statement obviously being the main culprit. Management commentary suggested that the 6-month backlog had "vanished" since its recent update in September, which caught investors totally offside. Post the update, sell-side analysts took a knife to profit expectations and revised FY24e earnings down ~20%.

Since then, the stock has continued to de-rate and the shares have sold off further to $26.77. We feel that at a PER of 12.7x FY23 recently downgraded earnings, this quality name which we have followed for decades and know very well, offers attractive valuation metrics once again. We are extremely confident that the shares have been significantly oversold and we would expect a strong rebound.



FUND STRATEGY AND OUTLOOK

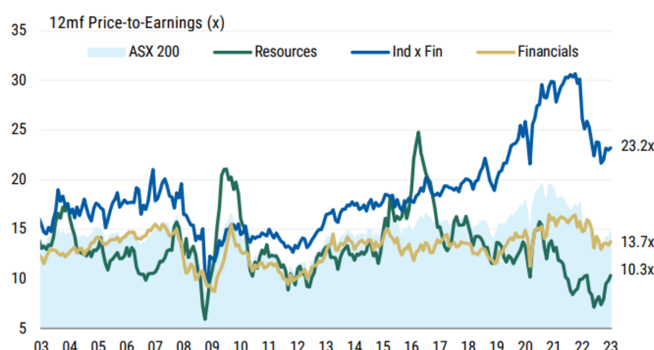
So far, equities have performed broadly in line with our previous expectations - front and centre are of course investors pre-occupation with central bank policy direction. However, concerns about a synchronised global growth slow down and fears of a sharp deceleration in economic activity are fast receding, 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.

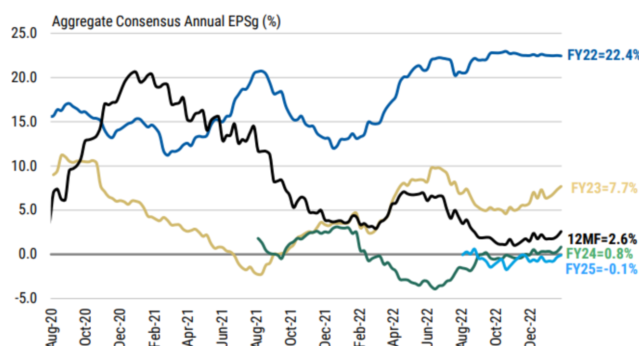
We have lived in a macro market for the last three years, driven by shocks: COVID, the biggest fiscal package ever and an aggressive Central Bank hiking cycle to curb outsized inflation. Now, assuming central banks are successful in taming inflation, micro factors should take over the reins. Sector dynamics, 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.

To summarise your portfolio's positioning:

1. Quality Franchises, Growth at Reasonable, Attractive Valuations

Solid companies with strong/leading market positions and credible management with good balance sheets.

Amcor, GPT Group, IRESS, Liberty Group, News Corporation and QBE Insurance

2. Businesses that are highly cyclical or seasonal in nature, that have faced headwinds

Heavily discounted companies with strong market positions and strategic assets, but very sensitive to economic conditions/seasonality/weather.

Ampol, Bega Cheese, CSR, Harvey Norman, James Hardie Industries and Reliance Worldwide Group

3. Turnarounds

Sound businesses that have historically generated poor returns, have been badly managed, resulting in poor execution of strategy and have under-earned versus their potential. These stocks are in a transition phase and we think earnings/returns will improve over the medium term. Out of favour with the market, somewhat contrarian positions.

Seven West Media, Treasury Wine Estates and United Malt Group

4. Deep Value Resource Plays

Stocks trading at discounts to NPVs, where much of the heavy lifting has been done (cost out, self-help deleveraging). Despite the recent correction in commodity prices, the cycle is still positive, paving the way for healthy dividends.

BHP Group, IGO, Iluka Resources, Northern Star Resources and Santos

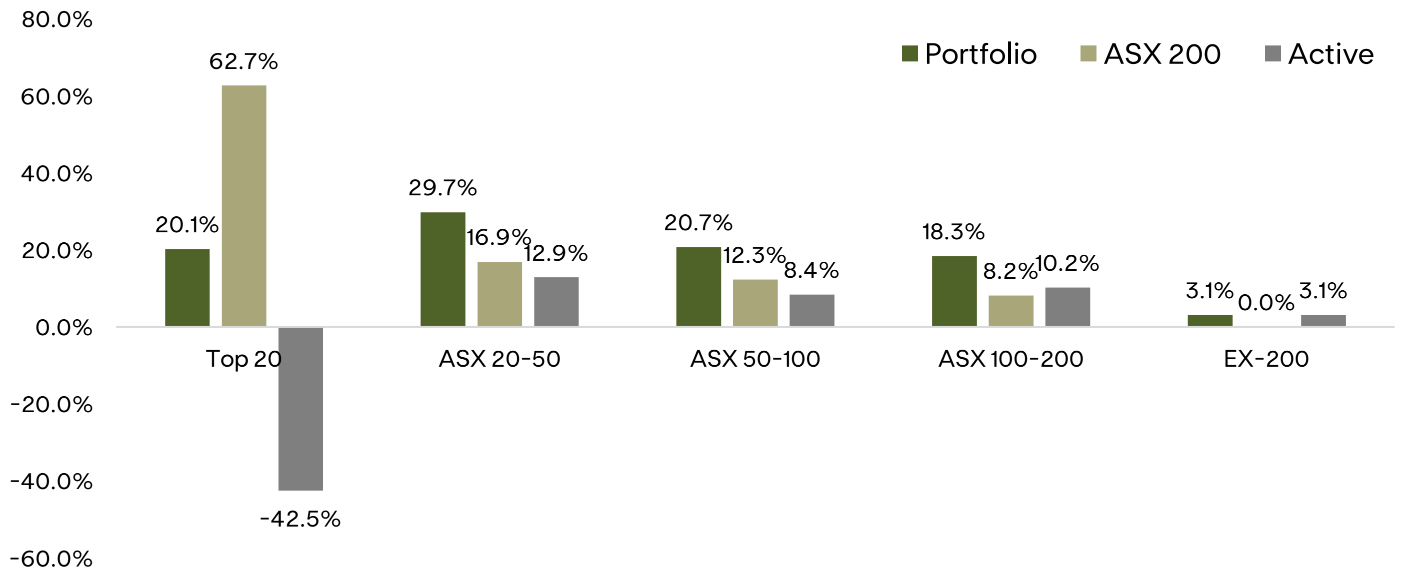
We are truly grateful for, and always appreciate your continued support.

Warm Regards,

Chris Kourtis
Portfolio Manager

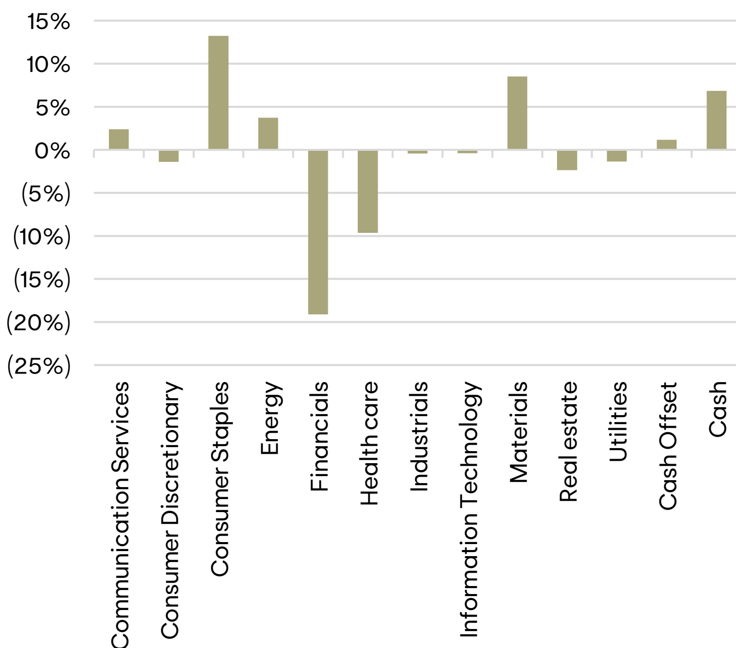
PORTFOLIO FEATURES

Size comparison Chart vs ASX 200^



^Size Comparison Data as at 31 January 2023.
Source: Factset, Ellerston Capital Limited.

Active Sector Exposures*^



TOP 10 HOLDINGS**
AMCOR
BHP GROUP
CSR
HARVEY NORMAN
IGO
QBE INSURANCE
RELIANCE WORLDWIDE.
SANTOS
TREASURY WINE ESTATES
UNITED MALT GROUP

Asset Class Exposures

Exposure (% of NAV)	Net
Equity	93.14
Long Option	0.00
Short Option	-1.15
Cash	8.01
Grand Total	100.00

* Active sector exposures are determined by subtracting Fund sector weights from benchmark weights. Positive percentages represent over-weight sector exposures relative to benchmark and negative percentages represent under-weight sector exposures relative to the benchmark.
^Index is FTSE Norges
** Top 10 Holdings are listed in alphabetical order.

ABOUT THE ELLERSTON OVERLAY ASF

The Fund aims to achieve its performance objectives by adopting a fundamental "bottom-up" investment approach to stock selection which is focused on identifying and then constructing a portfolio of the highest conviction ideas.

Investment opportunities for the Fund are identified by analysing and understanding the factors affecting (amongst other things): business model, industry structure, management team and overall valuation. Ellerston Capital typically favours businesses that can sustain high returns or improve their return on capital and looks to invest in businesses with a market value below the value we attribute to them.

Benchmark weightings do not drive our stock decisions, our approach is totally benchmark independent.

Due to the high conviction nature of the portfolio and the resulting deviation in portfolio composition relative to benchmark weighting, it is expected that the returns from the Fund will differ significantly from the broader market indices.

FUND FACTS

STRATEGY FUNDS UNDER MANAGEMENT	$208.3 Million
FUNDS UNDER MANAGEMENT – OASF UNIT TRUST	$9.2 Million
APPLICATION PRICE	$1.1113
REDEMPTION PRICE	$1.1057
NUMBER OF STOCKS	22
INCEPTION DATE	1 July 2011

Source: Ellerston Capital Limited.

Contact Us

Sydney

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+612 9021 7701
info@ellerstoncapital.com

Find out more

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

Should investors have any questions or queries regarding the Fund, please contact our Investor Relations team on **02 9021 7701** or **info@ellerstoncapital.com** or visit us at **ellerstoncapital.com**

All holding enquiries should be directed to our register, Automic Group on 1300 101 595 or ellerstonfunds@automicgroup.com.au.

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