Ellerston Global Mid Small Cap Fund

Monthly Newsletter, June 2023

Investment Objective

To outperform the MSCI World Mid Cap NR (AUD) Index by 3% over a rolling 5 year period on a net of fees basis, with a focus on risk management and capital preservation.

Investment Strategy

The Fund's investment strategy is to construct a concentrated portfolio of global mid small cap securities using the Manager's distinctively contrarian high conviction, benchmark independent investment approach. The Manager believes that the trade-off between risk and potential returns is improved by implementing the highest conviction ideas from a filtered universe of securities that are in a period of "price discovery" and offer the best risk/reward.

Key Information

Strategy Inception^^	1 March 2017
Portfolio Manager	Bill Pridham
Class A Application Price	$1.4053
Class A Net Asset Value	$1.4018
Class A Redemption Price	$1.3983
Class B Net Asset Value	$1.1889
Class B Redemption Price	$1.1859
Liquidity	Daily
No Stocks	20 - 40
Management Fee (Class A)	0.75%
Performance Fee	10%**
Buy/Sell Spread	0.25% on application 0.25% on redemption

**10% of the investment return over the benchmark return (MSCI World Mid Cap Index NR (AUD)), after recovering any underperformance in past periods.

Performance Summary

Performance	1 Month	3 Months	1 Year	3 Years (p.a.)	5 Years (p.a.)	Since Inception (p.a.)^^
Class A^	5.11%	6.37%	20.43%	10.38%	9.84%	11.52%
Benchmark*	3.21%	3.78%	16.40%	10.70%	7.70%	9.41%
Alpha	1.91%	2.59%	4.02%	-0.32%	2.14%	2.11%

Performance	1 Month	3 Months	1 Year	2 Years (p.a.)	Since Inception (p.a.)***
Class B^	5.11%	6.36%	20.53%	-1.37%	9.35%
Benchmark*	3.21%	3.78%	16.40%	1.42%	9.61%
Alpha	1.90%	2.58%	4.13%	-2.79%	-0.26%

^ The net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance.
* MSCI World Mid Cap Index NR (AUD)
***Class B Inception Date is 18 August 2020

The Ellerston Global Mid Small Cap Fund increased 5.11% net during the month of June compared to the MSCI World Mid Cap Index NR (AUD) Index which rose by 3.21% over the same period.

For the 12 months ending 30 June 2023, the Fund appreciated 20.43% and with the underlying benchmark increasing 16.40%, the net alpha generated for this financial year was just over 400bps.

ESG In Focus

At the start of the year, we wrote about the "Forever Chemicals" otherwise known as per and poly fluoroalkyl substances, or PFAS for short. If you remember, PFAS are used in a wide variety of modern applications however they have been found to accumulate in humans, animals and the environment over time (as they break down very slowly) with the potential to be very harmful to human health.

We have had a few major announcements from both public and private players post our initial blog that we would like to provide updates on:

The Environmental Protection Agency (EPA) is expected to come out with definitive standards around PFAS concentration and the number of PFAS compounds that will fall under the new regulations (likely announced in August 2023). The proposal will also be underpinned by the **distribution of $10bn in funding to combat PFAS** exposures.

In mid-May, Australian Prime Minister, Anthony Albanese, stated that PFAS has been an issue in many communities (especially around airports and military bases) where people have suffered, and he is concerned around the health outcomes of those affected by it. The Federal Government settled a class action over PFAS contamination and will **pay out $132.7m to landowners** at seven sites which were exposed to poisonous chemicals (PFAS) in firefighting foam.

More recently, on 02 June, The Chemours Company, Dupont and Corteva jointly announced that they had reached an agreement to resolve all PFAS drinking water claims associated with public water systems (PWS) that serve the vast majority of the US population. The **settlement will see $1.185bn** allocated to a settlement fund which can be access by the water districts associated with the agreement.

These settlements have subsequently been dwarfed by the announcement from 3M at the end of June that it has entered into a broad resolution to support PFAS remediation for PWS that detect PFAS at any level or may do so in the future.

3M has agreed to contribute up to $10.3bn (present value) payable over 13 years and will provide:

- ✓ Funding for PFAS treatment technologies for PWS across the US
- ✓ Funding for PWS that may detect PFAS in the future
- ✓ Funding for PWS nationwide to conduct testing for PFAS

Although it is still in the early stages and we haven't really seen any material spending allocations from outside the US, based on these announcements alone, **there is approximately $21.5bn already designated** to the testing and cleaning up of the PFAS contamination problem.

In the Ellerston Global Mid Small Cap Fund we have two businesses with direct exposure to addressing the PFAS issue which is really only starting to gain awareness and traction. Chart Industries has extensive experience in removing PFAS from water and provides a complete treatment system for its customers while Montrose Environmental provides both testing and remediation of PFAS in the US, Europe and here in many Australian military bases.

Portfolio Commentary

It does appear that global equity performance during the first half of calendar 2023 came in quite differently than many were expecting. We limped into the New Year with the S&P 500 down almost 6% in December 2022, ending CY2022 at just above 3,800 points. This set up had crystalised a view that the first half 2023 would see a continuation of this negative trend followed by a much stronger second half.

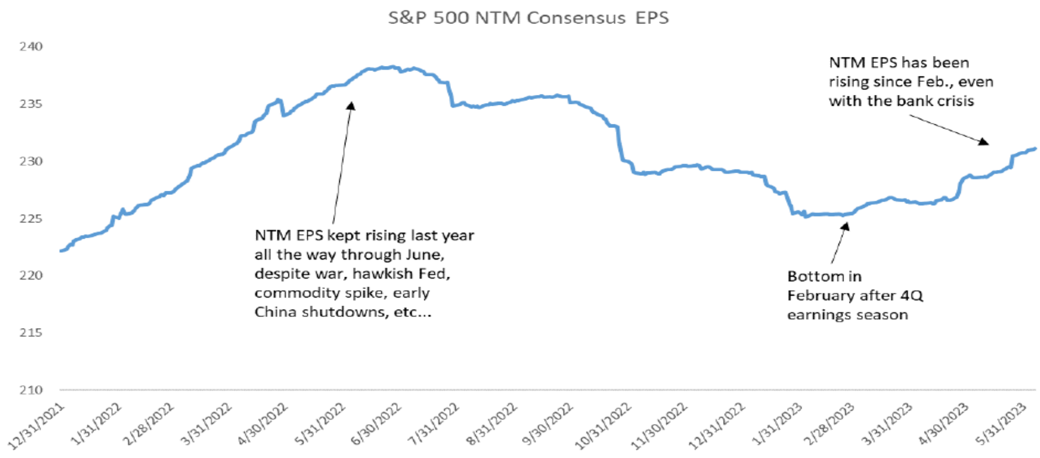
Despite having to deal with very soft global industrial activity levels, continued interest rate increases from the Fed and a regional bank crisis in the US (and one large international scalp with Credit Suisse) in which we experienced three of the five largest bank failures in US history, markets turned in very solid results with the S&P 500 up 16.9%, FTSE 100 up 3.2% German DAX Index up 16.0%, French CAC up 17.4% and the Japanese NKY up a very impressive 28.7% in the first 6 months of 2023.

It does seem the market is looking at the durability of US growth with nominal GDP in the US growing around 5.5% in the first half despite the aforementioned overhangs. The labour market remains very resilient despite the Fed's best efforts to dampen the tight labour market conditions. Housing seems to have stabilised at current levels with the sequential datapoints potentially improving from here. We noted some interesting comments from US homebuilder, Toll Brothers. in its earnings call at the end of May where CEO Doug Yearley stated that "Overall, buyers appear to be adjusting to mortgage rates that have stabilized in the 6% to 7% range. The shock of last year's abrupt spike in rates appears to be wearing off, and buyers are moving on with their lives". It seems that consumers, similar to businesses, are very adaptable to changing economic conditions.

The market is also liking the fact that inflation is trending lower globally (albeit at differing rates) with the latest reading in the US coming in at 4.0% which is well down from the peak of 9.1% recorded in July of last year. We are finally starting to see shelter and used car inflation moderate which is important as these two measures have really been holding up past CPI readings. We should see this downward bias continue with many expecting US headline CPI to decline into the low 3% range by year end. As this is consensus right now, the risk lies in a reacceleration similar to what we have recently seen in Canada and the UK.

As we highlighted earlier, many had expected weak sharemarket returns for the first half of the year and the main driver was a substantial downward adjustment to earnings expectations as margins get crimped in a slower economic environment. Interestingly, the opposite has occurred with earnings forecasts consistently being raised over the past couple of reporting seasons as results, and especially outlooks, have been better than expected.

Equity market performance is highly correlated with earnings expectations, both up and down. We can see in the following chart how earnings forecasts bottomed in February 2023 and have been on an upward trend since that point (similar to the market). It will be interesting to see how the second half performs as it does take time for restrictive monetary policy to work through the system.



Source: St. Louis Federal Reserve, Raymond James research

So with a solid start to calendar year 2023 how does the setup look into the second half?

With inflation waning there seems to be some hope priced into equities that the Fed will pivot and begin to cut rates. While it seems clear that we are closer to the end of the rate hiking cycle than the beginning, we contend that outside of a serious market damaging event, the Fed could maintain rates higher for longer than the market expects. With a firm focus on reigning in inflation (and especially inflation expectations) it really isn't consistent for policymakers to support markets while concurrently taming inflation and they will need several quarters to confirm that the job is done.

Labour markets and subsequently the consumer have been very resilient. As consumer balance sheets remain in great shape and the tight employment market provides a solid bid to wages, it does not seem like a serious consumer downdraft is on the cards. That said, with inflation eating into past savings it is also difficult to envision an uptick in discretionary spending.

We have experienced one of the fastest rate hiking cycles in generations and when coupled with more restrictive lending standards associated with the US regional bank crisis, liquidity required to grease the economic wheels does seem more restrictive. Tighter financial conditions typically takes time to work its way through the economy so we many see more of an impact later this year and into next. While inflation is moderating now, any perceived reacceleration remains a concern for the market as the rate hiking cycle would then have further to go. In this environment, good data would be bad (higher rates) while bad data could underpin the risk of entering a recession.

As we discussed in our last letter around a potential recession, hard landing, soft landing, no landing – we have no edge on predicting the outcome however do consider that the tightening of financial conditions, coupled with the recent US regional bank stress, should lead to a slowing of economic activity which would impact earnings. We remain steadfast in our approach in identifying and investing in businesses with strong secular or structural growth opportunities. While these companies will not be totally immune from a slowing economy, they should be relatively insulated and come out the other side in an even stronger competitive position.

The Ellerston Global Mid Small Cap Fund increased 5.11% net during the month compared to the MSCI World Mid Cap Index NR (AUD) which rose by 3.21% over the same period.

The portfolio's top three contributors **Chart Industries, Azek and Option Care Health added 269bps to performance** while **Ciena, Rentokil and Cellnex Telcom detracted 59 bps** during the month.

Chart Industries is a leading global manufacturer of highly engineered equipment servicing multiple applications in the Energy and Industrial Gas markets. It is recognized as a leader in the clean energy transition by providing technology, equipment and services related to liquefied natural gas (LNG), hydrogen, biogas, carbon capture and water treatment to global customers. We met with Management at a broker conference in Boston in early June at which the company provided an update on its Howden acquisition. Synergies are coming in stronger and quicker than expected while both Howden and Chart core businesses are benefiting from record order books. On June 12, Chart announced the sale of a non-core asset for $300m which is the first of $500m expected to be realised over the coming months. This will go a long way towards deleveraging the balance sheet and the market applauded.

Azek operates in basically a duopoly with Trex in the US composite decking market which is benefiting from the long term shift from wood to composite. While there were no stock specific announcements, Azek benefited from improving housing sector metrics and taming rate expectations which drove solid performance from the home building sector. The composite decking market had been overstocked last year however both Azek and Trex made concerted efforts to clean out excess supply and now operate in a more normalised supply/demand setup.

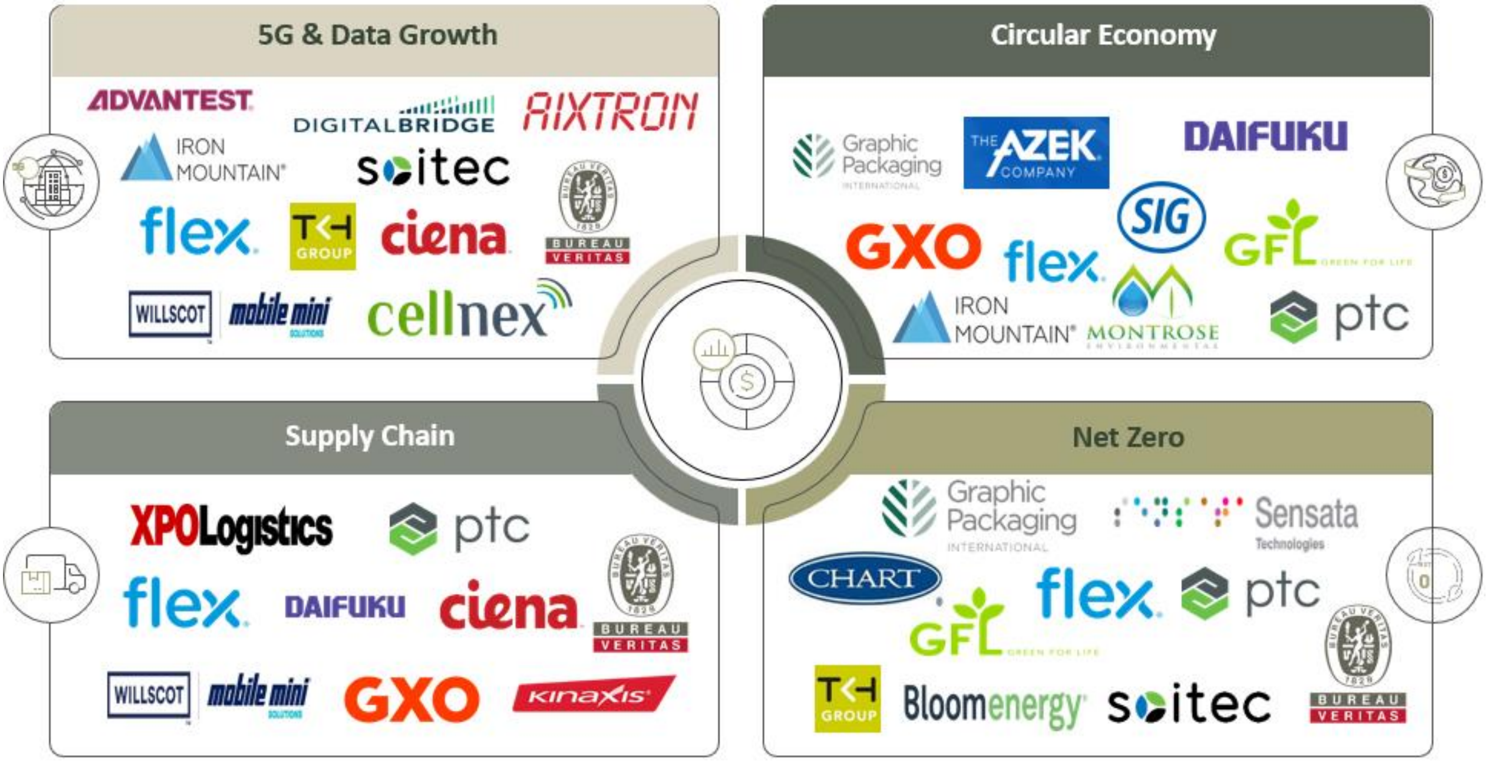
Option Care Health was a key detractor last month on the back of its proposed acquisition of Amedisys. While we could see the vision and attractiveness of combining the two businesses, the risk around Medicaid reimbursement was a key concern. Well, another company viewed the attractiveness of Amedisys as an opportunity with UnitedHealth's Optum unit bidding $100/share in cash (OPCH was all scrip) in the first week of June. The bid was subsequently accepted by Amedisys and at the end of June, OPCH announced that it would terminate its merger agreement with Amedisys. As shareholders we will receive a $106m break fee which we anticipate will be returned as a share buyback.

Ciena is a market and technological leader in providing networking systems, services and software. The core of its business is driven by the growth in data as its optical solutions help "light up" the fiber connecting data centers and subsea cables that connect continents. Ciena delivered above market earnings in its second quarter result which was released in early June, however as telecom players such as Verizon and AT&T look to prioritize cash flow, some projects will get pushed out to 2024. This resulted in revenues now expected to grow 18-22% vs the 20-22% previously expected. Management is not seeing cancellations and expect to exit 2023 with a backlog double historical levels which should provide some good revenue progression for 2024.

There was really nothing out to explain the weakness in Rentokil or Cellnex Telecom during the month. Both stocks have performed quite well over the past 6 months with Rentokil up 21.1% and Cellnex up 19.6% so perhaps a bit of digestion.

With strong share price performances over the past several months we have trimmed some of our positions to lock in some profits. We have highlighted the absolute share price performance over the past six months in brackets for those stocks we trimmed in June: XPO (+77.2%), AZEK (+49.1%), Advantest (125.8%), Digital Bridge (34.5%), Flex (28.8%) and GXO Logistics (47.2%). We added to our position in GFL Environmental to make it our largest position currently.

We continue to have differentiated exposure to some pretty powerful long term thematics which should drive long term compounding benefits to us all as investors. These include 5G and the growth in data as Industrial IoT, AI and large language networks such as ChatGPT and next generation applications associated with 5G drive data demand, companies that enable our push to a circular economy, beneficiaries of deglobalisation as well as those helping to improve supply chain efficiency and companies which are levered to the multi trillion-dollar spending required for our "Road to Net Zero".



Source: Ellerston Capital

These businesses as well as idiosyncratic opportunities in the fund should provide solid absolute and relative returns over the long term as secular and structural business drivers help mitigate earnings risk in times of economic uncertainty.

As always, we thank you for your continued support and look forward to providing further updates in the future.

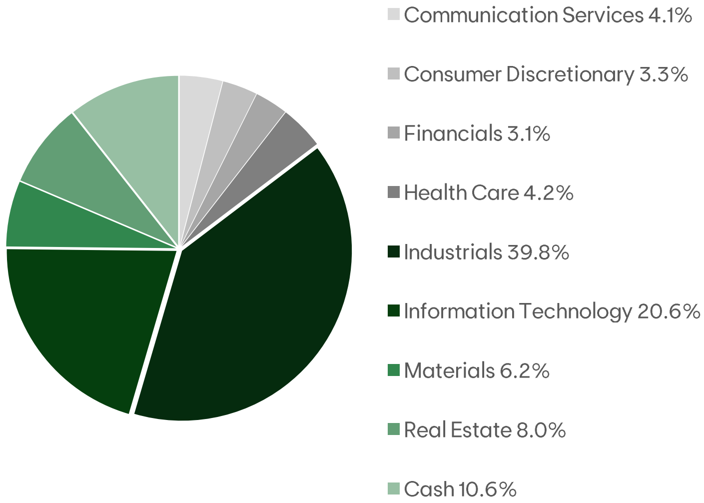
Portfolio Characteristics

Holdings

Company	Country	Sector	Portfolio Weight
GFL Environmental Inc	Canada	Industrials	5.8%
PTC Inc.	United States	Information Technology	4.9%
WillScot Mobile Mini Holdings Corp. Class A	United States	Industrials	4.3%
Chart Industries, Inc.	United States	Industrials	4.2%
Option Care Health Inc	United States	Health Care	4.2%
Cellnex Telecom S.A.	Spain	Communication Services	4.1%
Graphic Packaging Holding Company	United States	Materials	4.0%
GXO Logistics Inc	United States	Industrials	3.8%
TKH Group N.V. Cert	Netherlands	Industrials	3.6%
Ciena Corporation	United States	Information Technology	3.5%

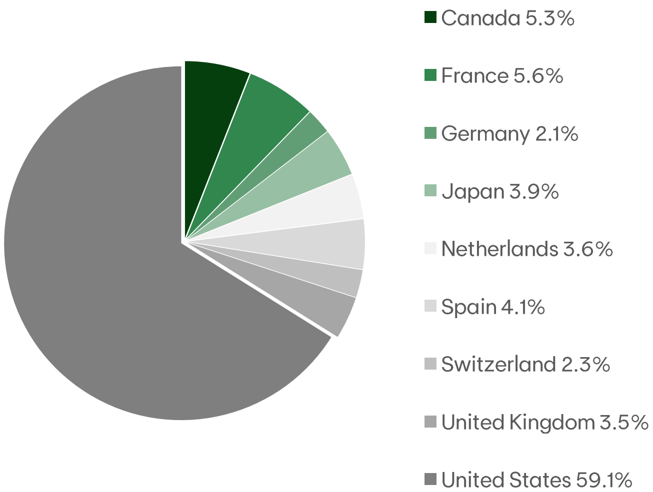
Source: Ellerston Capital

Sector Allocation



Source: Ellerston Capital.

Geographic Allocation



Source: Ellerston Capital.

Regulatory Guide (RG240) Fund Disclosure Benchmark – Periodic Reporting (monthly)

- **Net Asset Value of the Fund and Redemption Price of Units**
  Please refer to details on page one.

- **Any changes to key service providers including any change in related party status**
  There have been no changes to key service providers, including any change in related party status.

- **Net returns after fees, costs and relevant taxes**
  Please refer to details on page one.

- **Any material changes to the Fund's risk profile and strategy**
  There have been no changes to the Fund's risk profile and strategy.

- **Any material changes related to the primary investment personnel responsible for managing the Fund**
  Please refer to details on page one; there have been no changes to the primary investment personnel responsible for managing the Fund.

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Find out more

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

All holding enquiries should be directed to our register, Mainstream Fund Services on **02 8259 8550** or **InvestorServices@MainstreamGroup.com**

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