

Ellerston Equity Income KIS Fund

Monthly Report as at 30 June 2024

APIR Code: ECL7259AU | ARSN 662 683 123



Concentrated portfolio of 30-40 Australian listed securities that display stable and growing dividend streams.



Looks beyond traditional "income sectors" (e.g., banks and telecoms), recognising "cyclical sectors" are now experiencing structural shifts towards the provision of more reliable income.



Aims to provide investors with returns and income growth greater than the Benchmark over rolling five-year periods.

Performance Summary

Performance	1 Month	3 Months	FY24	3 Years (p.a.)	4 Years (p.a.)	5 Years (p.a.)	Since Inception (p.a.) ^^
Fund Net Return^	1.79%	-2.54%	9.18%	5.49%	10.93%	8.65%	8.81%
Benchmark*	1.01%	-1.05%	12.10%	6.37%	11.36%	7.26%	8.13%
Alpha	0.78%	-1.49%	-2.93%	-0.88%	-0.43%	1.39%	0.68%

^The net return figure is calculated after fees & expenses, assuming all distributions are reinvested. Past performance is not a reliable indication of future performance.
*S&P/ASX 200 Accumulation Index. ^^Inception date is 1 May 2019.

Key Information

Portfolio Manager	Chris Kourtis
Investment Objective	To provide investors with returns and income growth greater than the Benchmark over rolling five-year periods.
Benchmark	S&P/ASX 200 Accumulation Index
Liquidity	Daily
Target Number of Holdings	30-40
Number of Holdings at Month End	32
Minimum Investment	Initial investment - \$10,000 Additional investment - \$5,000
Distribution Frequency	Quarterly (where available)
Management Fee	0.70% p.a.
Performance Fee ¹	10.00%
Buy/Sell Spread	0.25% / 0.25%
Strategy FUM ²	\$81.72m
Platform Availability	HUB24, Netwealth
Lonsec Rating ³ SQM Rating ³	Recommended Superior / 4.25 Stars

¹Of the investment return above the Benchmark, after recovering any underperformance in past periods.

²Funds invested across all Equity Income KIS strategies.

³Lonsec Rating assigned 31 May 2024. SQM Rating assigned 6 October 2023.

The Team



Chris Kourtis
Director & Portfolio Manager

39 years of industry experience.



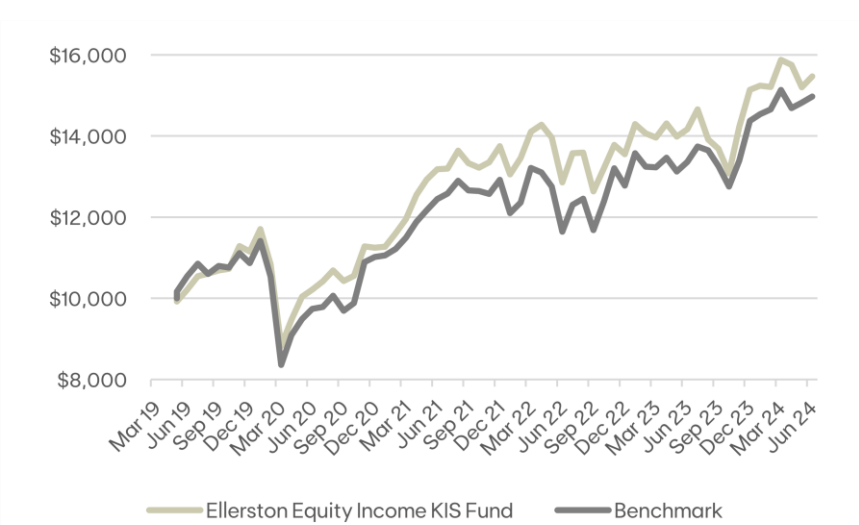
Stephen Giubin
Senior Investment Analyst

36 years of industry experience.

FY24(e) Key Portfolio Metrics	Fund	Benchmark
Grossed Up Dividend Yield (%)	7.4	5.1
Dividend Yield (%)	6.0	3.8
Price/Earnings (x)	12.8	17.3

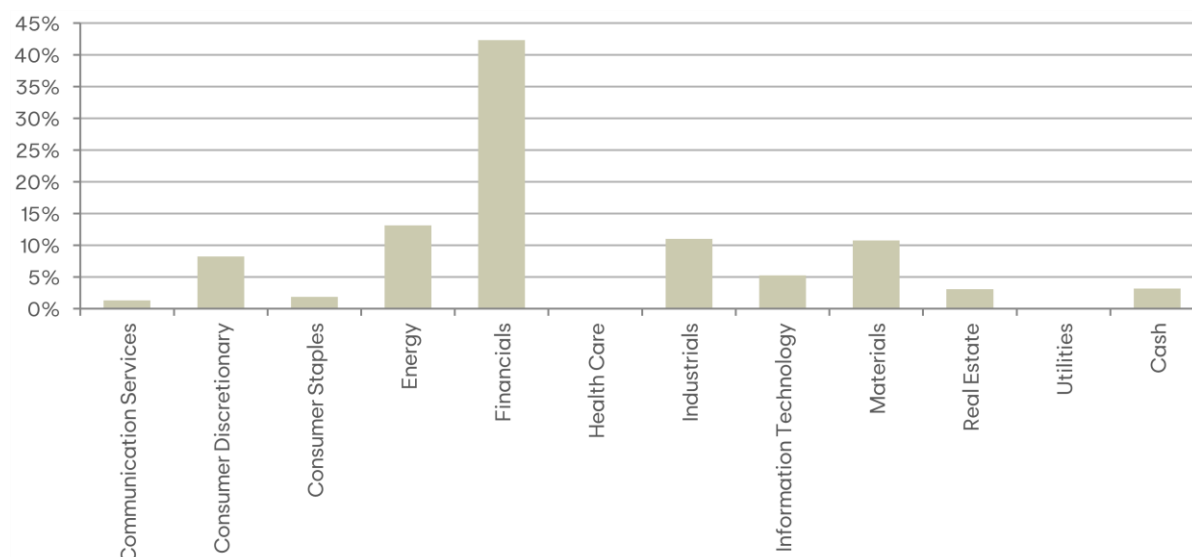
Source: Ellerston Capital.

Growth of \$10,000 Investment



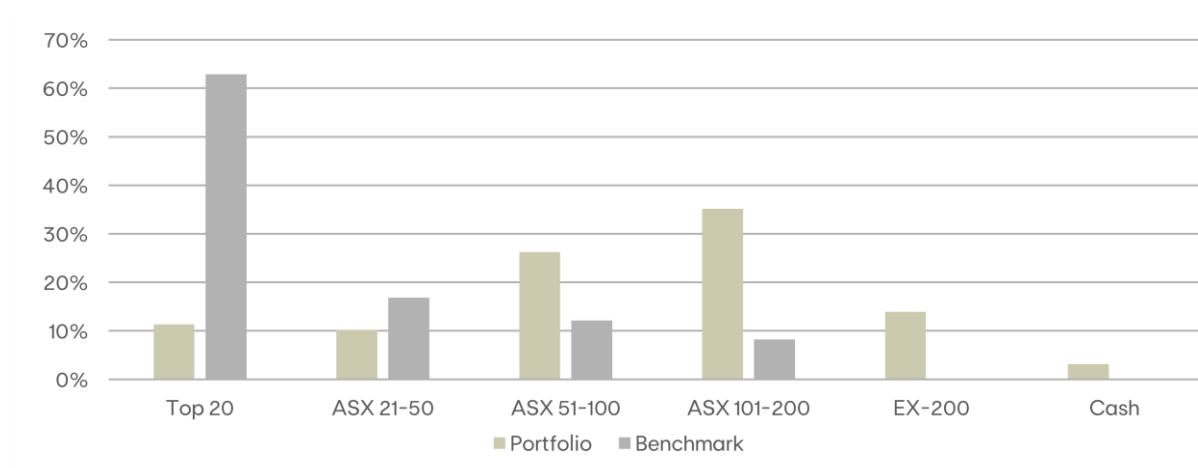
Fund Performance shown is net of fees, assuming all distributions are reinvested.
Past performance is not a reliable indication of future performance.
Source: Ellerston Capital.

Sector Allocation



Source: Ellerstun Capital.

Exposure by Market Capitalisation



Source: Ellerstun Capital.

Top 10 Holdings*

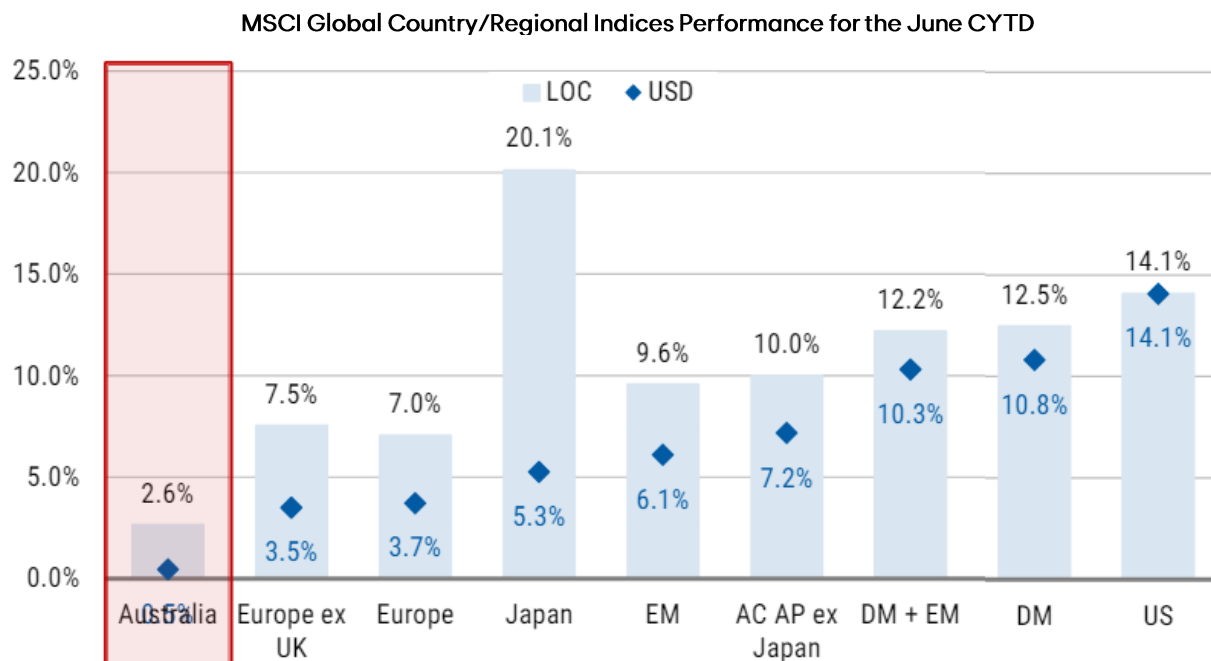
Ampol
Atlas Arteria
Bapcor
GQG Partners
Insignia Financial
IRESS
Liberty Financial Group
Medibank Private
Orora
Perpetual

* In alphabetical order.

Source: Ellerstun Capital

MARKET OVERVIEW

The upward momentum in equity markets continued in June, driven by the Magnificent Seven powering the Nasdaq to close up 6.0%. The MSCI Developed Markets World Index (DM) squeezed 2.4% higher, with the US proving the strongest region by returning +3.6%. Emerging Markets outperformed DM to finish up 4.3% in local currency terms, fuelled by the continued strength in India's SENSEX and the tech heavy Korean market. The S&P 500 rallied 3.6%, with IT leading the GICS sector charge (+8.8). Meanwhile domestically, the S&P/ASX 200 underperformed the DM performance, rising by a more modest +1.0%. Globally, IT and Communication Services were the two best performing sectors in the month of June and domestically, it was Financials (+5.1%), Consumer Staples (+4.6%) and Utilities (+4.6%) that led the charge.



Source: Morgan Stanley

USA

The Federal Reserve (Fed) left its benchmark rate unchanged in a range of 5.25% to 5.5% for a seventh straight meeting, coinciding with the May CPI report which was released on the same day. Chair Powell acknowledged the friendlier CPI inflation news, but caveated that it came "after several reports that were not encouraging." Chair Powell also stated that he wanted to see more. "One reading isn't - it's just only one reading. You don't want to be too motivated by any single data point" he stressed. The June dot plot delivered a hawkish surprise, with a median projection of one cut in late 2024, instead of the two that consensus had expected. Chair Powell emphasized in his press conference that many Fed participants saw it as a very close call and that both options were still plausible outcomes. The market-implied probability of a cut by September rose from 59% to a peak of 85% after the soft CPI report and then fell to 65% immediately after the FOMC meeting. The Bank of Canada became the first major central bank among the Group of Seven countries to cut interest rates by lowering official rates by 25bps to 4.75%. They might have jumped the gun, as a hot May inflation number of 2.9% was printed, up from 2.7%, which may spook other Central Banks from following suit.

The NASDAQ Composite (+6.0%) and the S&P 500 (+3.6%) were both major beneficiaries of the Magnificent One (NVIDIA) which finished +12.7% (+149% CYTD), followed by the Dow Jones Industrial Average, +1.2%, with the Small Cap Russell 2000 the laggard, returning -0.9%.

Europe

The ECB cut rates by 25bps, the first since September 2019, as previously telegraphed by a number of ECB members. However, ECB president, Christine Lagarde added that there were still risks to the outlook for inflation, saying: "Despite the progress over recent quarters, domestic price pressures remain strong, as wage growth is elevated and inflation is likely to stay above target well into next year".

The Euro STOXX50 Index finished the month down 1.7%, impacted by election fever (with an unexpected snap election called for by Emmanuel Macron in France). Among the major exchanges, the FTSE 100 was down 1.1% followed by Germany's DAX which fell 1.4% and France's CAC 40 was the clear laggard, closing 6.3% lower on fears Marine Le Pen's far-right National Rally alliance would gain political traction to secure an absolute majority, as indicated by the early polls (notoriously wrong).

Asia

China's economic activity has been choppy in 1H, starting strong in 1Q (the notable exception was the housing sector and housing-related consumption). Economic activity generally recovered in 1Q, led by industrial production, manufacturing investment and an increase in export volumes. However, with the fading of Lunar New Year effect and withdrawal of policy support (as reflected in the net decline in government bond issuance and broad credit data), activity has cooled off in 2Q. The divergence continued, with out-performance in advanced manufacturing, green sectors and exports, offset by under-performance in housing market activity and in between, modest growth in infrastructure FAI, consumption and services. These imbalances, especially weaker domestic demand vs. supply, have not surprisingly led to prolonged deflationary pressure. China's top leaders will gather from July 15 to 18 for their highly anticipated meeting known as the Third Plenum. The Third Plenum carries historical significance and has previously spurred transformative periods of China's economic policy. All eyes will be focused on this meeting, but that said, market expectations are low heading into the event (with equities down 10% from their May peak).

Asian markets performances were mixed, but generally underperformed the US and most European markets. India's SENSEX charged ahead with a return of +7.1%, driven by its economy growing at over twice the rate of global GDP, followed by Korea's KOSPI which rose 6.1% and the Nikkei which returned +3.0%. The Hang Seng was down 1.1% and China's SSE was the underperformer, falling 3.0% as protectionism has increased leading to negative revisions to demand, especially EVs and bond issuance has lagged.

Commodities

Consistent with global developments, Chinese concerns have weighed on commodities. Iron ore prices weakened due to rising port inventories, down 7% to US\$107/tonne and coking coal prices fell 3% to US\$234/tonne. The base metals complex also seemed to run out of steam, with aluminium down 4%, copper falling 5% and nickel collapsed by 12.0%. Crude oil bounced back 5.0% to close at US\$85/barrel, with OPEC+ extending production cuts, however the group stressed that increases in production could be "paused or reversed subject to market conditions." Gold finished flat at US\$2327/oz (equivalent to A\$3433/oz), despite the US dollar being stronger on a trade weighted basis.

Bonds

The US 10-year bond yield was reasonably stable, retreating by 10bps to 4.40%. Treasuries reacted positively to the May core CPI print late in the month and also by the better Core PCE Deflator which followed. The Australian 10-year bond yield was also modestly lower, despite the hot May CPI release, finishing -10bp at 4.31%. The A\$ closed the month flat at US\$0.67, despite weaker commodity prices.

Australia

As expected, the RBA stayed on hold when they met for their June rate decision, not materially changing their policy guidance, without reinstating an explicit tightening bias. However, Governor Bullock highlighted a few hawkish indicators, namely the tick up in April inflation and recent budget outcomes which may have an impact on end demand, though she conceded that federal and state energy rebates kicking in will temporarily reduce headline inflation. The May CPI, released in late June, was again worse than expected, setting the cat amongst the pigeons. Headline inflation came in at 4.0% versus consensus of 3.8% (off the December trough of 3.4%), with the RBA's preferred Trimmed Mean also re-accelerating to 4.4% (also well off trough of 3.8% in January). This puts the RBA in a precarious position, with the probability of a rate hike now back on the agenda at the next RBA meeting to be held on August 5-6.

Australian equities consolidated their gains and nudged higher in June. The S&P/ASX 200 Accumulation Index closed up 1.0%, with Financials, Consumer Staples and Utilities the best performers. Financials (+5.1%) were driven by leaders CBA (+6.6%), NAB (+6.8%), Macquarie (+7.2%) and Westpac (+4.8%), followed by Consumer Staples (Woolworths +6.9%) and Utilities (Origin Energy +6.6%). The worst performing sectors were Materials (-6.5%), dragged down by the major miners (BHP -4.1%, Fortescue -13.5%, Rio Tinto -7.7% and Mineral Resources -24.8%), followed by Energy (Paladin Energy -21.7%) and Industrials (Reliance Worldwide -6.8%).

For the month, the top stocks that made a positive contribution to the Index's return were CBA (+57bps), CSL (+32bps), NAB (+31bps), Macquarie (+21bps) and Westpac (+19bps).

Conversely, the bottom five stocks detracting from the Index's performance were mining stocks BHP (-41bps), Fortescue (-24bps), Rio Tinto (-16bps), Mineral Resources (-13bps) and Pilbara Minerals (-9bps).

The ASX Small Ordinaries bucked the trend to close down 1.4%, worse than the broader benchmark of +1.0%. Within the ASX Small Ordinaries, the Small Industrials fared particularly well, up 1.4% versus the Small Resources, which returned -8.0%. The worst performing Small Cap was former market darling Cettire, plunging 49.8% after the online fashion retailer's shock profit downgrade which left investors scratching their heads.

The rise in the broader market in June leaves FY24 performance for the Australian equity market at 12.1%. By sector, Financials was the clear standout, up a whopping 29.2%, just pipping IT at 28.4% and REITs at 24.6%, whilst Consumer Staples delivered the lowest return for the financial year (-3.7%).

COMPANY SPECIFIC NEWS

The Market Hits

Strike Energy (STX +40.0%)

Western Australian gas developer STX has a reputation of reserves downgrades which has seen its stock price fall ~50% this year. Late in June, STX announced another downgrade to its South Erragulla reserves of 65% from 128PJ to 45PJ. At the same time, STX announced a pivot in development concept from domestic gas sales to an 85MW gas peaking power project, to achieve significantly higher average realised gas prices. Project capex is estimated at \$120-160m, with an award of electricity capacity expected in Aug-24, and FID by Nov-24, to support first sales in Oct-26. The development was taken positively as their forecast for 4x higher revenue more than offset the 65% lower reserves.

Bapcor (BAP +20.9%)

BAP was the latest company to garner M&A attention, after Bain Capital lobbed an unsolicited A\$5.40 per share conditional, non-binding cash takeover offer for the embattled company. The stock rallied in response, but is still trading well below the terms, with a lot of water to go under the bridge.

Pro Medicus (PME +19.3%)

PME provides a range of radiology information technology software and services to hospitals, imaging centres and health care groups. PME remains a very high multiple stock trading at ~90 times price/sales and an eye watering EV/EBITDA multiple of 120x, supported by its ~30% p.a. expected revenue growth rate - the main driver and focus for investors. Swedish company Sectra, one of PME's main competitors, reported its FY24 result delivering revenue growth of 23%, appreciably lower than PME at ~30%. This highlighted that PME remains ahead of the competition on revenue growth as well as margins, and transition to the cloud/SaaS model. More wood on the fire for PME investors saw the stock price rise 18%, clocking up an impressive 110% return for FY24.

Healius (HLS +18.1%)

HLS reacted positively to news reports that it was close to selling its Lumus Imaging business, the country's third-largest diagnostic imaging unit behind Sonic Healthcare and Permira's I-MED, which has also been considering a sale. Further, Integral Diagnostics announced that it had agreed to merger terms with Capitol Health for a price equating to an EV/EBITDA multiple of 10x, signalling that Lumus (given its larger scale), would achieve a price of at least \$700m. This ray of sunshine pushed the stock higher, despite yet another earnings downgrade later in the month.

Insurance Australia Group (IAG +15.2%)

On the last trading day of the financial year, IAG updated the market and announced changes to their reinsurance program by exiting their aggregate cover, while picking up a stop-loss and adverse development cover (ADC) for its long tail portfolio. IAG has entered into new long-term reinsurance agreements with a Berkshire Hathaway subsidiary and Canada Life Reinsurance, for 5 years that essentially provides natural peril protection of up to \$680m p.a., up to \$2.8bn over the next 5 years. Their FY24 reported margin guidance was also upgraded to the top of the range (\$1200m to \$1450m) including the additional ADC cost, while the underlying margin is expected to be at the mid-point of the 13.5-15.5% guidance. The market liked the update, pushing up IAG by 7%.

Tabcorp Holdings (TAH +13.8%)

Bombed out and unloved TAH finally reacted positively to the NSW Government's announcement to establish a formal process to consider reforms to the NSW wagering tax regime, regulation and industry funding. If implemented, this would create a level playing field and modernise retail exclusivity, similar to recent reforms in Victoria and Queensland. The market also liked the appointment of a new CEO, Gill McLachlan.

Steadfast Group (SDF +12.0%)

Insurance broker and underwriter SDF pleased the market by upgrading FY24 guidance ahead of their investor day. SDF guided to underlying EPS growth of 16%-17%, well ahead of consensus expectations sitting at 12%. The investor day eased concerns around a shrinking domestic acquisition runway which the company sees for another ~15 years, through dial-ups in existing equity brokers, authorised representatives and identified trapped capital opportunities from non-equity brokers.

Light & Wonder Inc. (LNW +11.7%)

Light & Wonder is a very well managed leading cross-platform global games company in the US and internationally, operating through three core segments: Gaming, SciPlay and iGaming. LNW caught some of the tailwind from Aristocrat's recently delivered strong result, with the Board approving a new three-year share repurchase program for up to \$1 billion in outstanding common stock through to June 2027. The prior share repurchase program, which authorized the Company to repurchase up to \$750 million of its common shares, was set to expire in February 2025. As of mid-June, the Company has exhausted the full \$750 million share repurchase authorization, purchasing 11.5% of shares at sensible prices since the inception of the program. A couple of major sell-side initiations espousing a positive view also helped the shares strengthen further. Since listing in Australia, it's been one of the ASX's star performers, with the Board (Chaired by veteran Jamie Odell) and management not putting a foot wrong.

Aristocrat Leisure (ALL +10.8%)

ALL's solid price momentum continued into June, with the shares hitting an all-time high after posting a 10% better-than-expected result in May. The update drove consensus upgrades and ALL's capital management improvements, encompassing higher dividends and a \$350m buy-back extension to \$500m were well received.

Treasury Wine Estates (TWE +9.8%)

TWE released its Treasury Americas Luxury Estates Investor Presentation and F24 guidance reaffirmation, focussing on TWE's recent acquisition of DAOU. TWE maintained their mid to high single digit FY24 EBITs growth guidance, which was taken positively given the backdrop of a weak consumer and ongoing US wine market challenges, also flagged by peer group companies in the past few months. Importantly, the DAOU EBITs guidance of US\$24m was bang in line with expectations, pacifying the DAOU doubters, at least for the time being.

The Market Misses

Cettire (CTT -49.8%)

Cettire (CTT) provided an update midway through June which was way below market expectations as follows; FY24 net sales revenue of \$735-\$745m, FY24 EBITDA of \$32-35m, claiming a softening demand environment and an increase in promotional activity as the market entered the Spring/Summer 24 sale period. To continue to expand its market share, the company selectively participated in promotional activity, leading to an increase in marketing costs relative to sales and a decline in delivered margin. CTT's 2H24 EBITDA guidance was ~60% below consensus, with the sticker shock being CTT making virtually no EBITDA in 4Q24 (vs. \$32M already booked YTD). The downgrade was almost entirely margin driven (GM, marketing), with CTT calling out 'aggressive competitor clearance' as the key driver. Promotions in the past were typically supplier funded, however it appears CTT has shouldered a greater share of this in June, or invested over and above what suppliers were funding, raising questions in the eyes of the market of CTT's structural growth through 'market share expansion' vs cyclical factors. This had severely impacted CTT's delivered margin and increased marketing % to sales. Obviously, part of CTT's downgrade was cyclical (weak consumer), however its change in pricing policy and recent inquiry into its business practices will have also contributed to its downgrade.

Liontown Resources (LTR -30.4%) / Arcadium Lithium (LTM -25.9%) / Mineral Resources (MIN -24.8%) / IGO (IGO -19.3%) / Pilbara Minerals (PLS -19.0%)

After bouncing ~30% from the bottom in March 2024, spodumene prices retreated sharply (~16%) in June and with it, lithium stocks took a hammering. The historically low level of investment in lithium supply capacity contributed to the supply shortage which endured throughout 2022. Since then, investment in new supply capacity has ramped up significantly, incentivised by the price highs seen in 2022. The resultant increase in supply from these projects primarily coming online in 2024-25 from Chinese based assets, concerned investors. Given the China integrated battery and EV structures, the cost curve is far less relevant and lower input costs are targeted rather than overall lithium project profitability. During the month, a number of sell-side analysts and third-party experts have been pushing out the length of the oversupply price pressure now to 2028, before seeing the return to high prices experienced back in 2022. It seems that the lithium bubble has burst, at least for now.

Paladin Energy (PDN -21.7%) / Deep Yellow (DYL -18.5%) / Boss Energy (BOE -11.6%)

Uranium companies have been the place to be in the past year or so, with spot prices more than doubling from US\$50/lb to a high of US\$105/lb in February and local stocks performing in step. Since then, U3O8 prices have drifted 18% lower, with a decent fall of 5% in June and as expected, the listed securities have fallen more than the spot price. PDN fared worse after announcing an all-scrip merger with Canadian developer Fission Uranium Corp. (FCU) at a 28% premium. There's nothing like high commodity price forecasts to stimulate M&A, enticing corporates to go on non-organic fishing expeditions.

Red 5 (RED -20.0%)

RED's all scrip merger with Silver Lake Resources (SLR) was completed during the month, with some large SLK investors cashing out when they received their allocated shares, putting pressure on RED.

Nickel Industries (NIC -16.7%)

Indonesian nickel producer NIC got hammered in line with the 12% fall in nickel prices in June. Base metals were generally weaker, in line with the softer China manufacturing data, however, nickel did much worse due to the unwinding of the recent short covering rally. Ironically for NIC, the overhang of Indonesia's increased production and further planned capacity additions remain a deadweight for nickel prices, with Indonesia likely to reach 70-75% of global supply by 2028/29 (up from 55% last year).

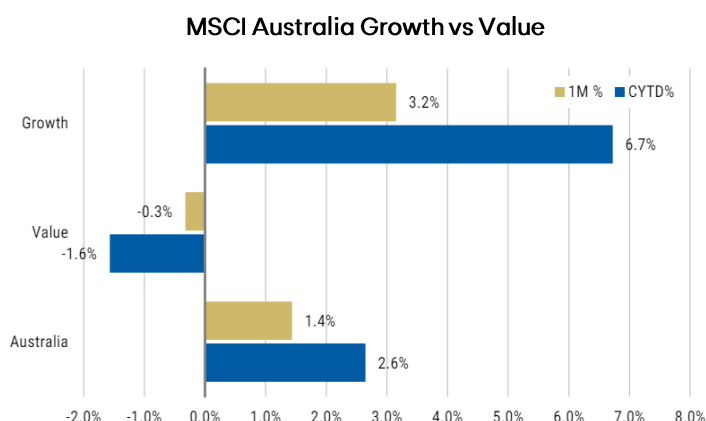
FUND PERFORMANCE

Against the backdrop of stronger offshore markets, domestic equities continued to lag, finishing up 1.0% for the month, lifting the FY24 total return to +12.1%. In the month of June, the Financials +5.1%, Consumer Staples +4.6%, and Utilities +4.6% sectors were the best performers, whilst Materials -6.6% and Resources -6.02%, were the worst sectors, dragged down by BHP (-4.1%), FMG (-13.5%) and base metal stocks.

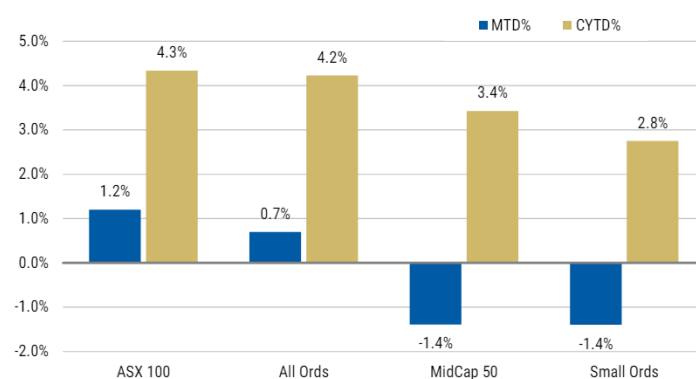
Pleasingly, the Fund return of +1.85% in June outperformed the Benchmark return of +1.01%, but capped off a bewildering year for the Fund, whereby our FY24 performance of +9.94% was modestly behind the Benchmark at +12.10%, but comfortably above the average official cash rate return of 4.21% for perspective. Most of our underperformance was due to our zero weight to banks which returned a staggering 34.9%, despite negative earnings revisions, as well as being significantly underweight REITs which returned +24.6% for the year. This acted as a huge headwind. During this period, our selectively contrarian, more Value oriented and Ex-Top 20 size bias remained out of favour in a market still chasing Big Caps, Tech, Growth, FOMO and was highly Momentum driven (refer below table).

For an income yield Fund, the 5-year performance of +9.71% p.a. is materially higher than the ASX Benchmark return of +7.26%.

Growth outperformed Value during June, and for the CYTD



Large Caps outperformed in June and CYTD



Source: Morgan Stanley

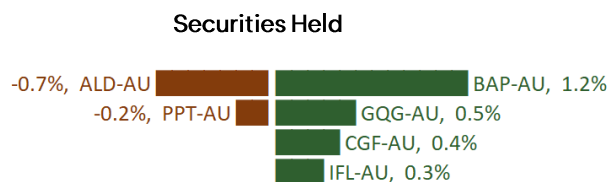
Financials, which rallied 5.1%, posted the largest contribution (+153bps) to the market's return during the month of June, driven by three of the major banks; CBA (+6.6%), NAB (+6.8%) and Westpac (+4.8%). Health Care followed (CSL +5.4%) and the Consumer Discretionary sector, +3.1% (driven by Aristocrat Leisure +10.8%), also outperformed.

Conversely, Materials (BHP -4.1%), Energy (Paladin Energy -21.7%) and Industrials (Reliance Worldwide -6.8%) acted as the major drag on the broader market.

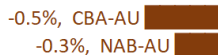
Returns (%)*	Gross	Benchmark	Excess	Net
1 Month	1.85%	1.01%	0.84%	1.79%
3 Months	-2.37%	-1.05%	-1.32%	-2.54%
FY24	9.94%	12.10%	-2.16%	9.18%
3 Years (p.a.)	6.48%	6.37%	0.11%	5.49%
4 Years (p.a.)	11.94%	11.36%	0.58%	10.93%
5 Years (p.a.)	9.71%	7.26%	2.45%	8.65%
Since Inception (p.a.)^^	9.86%	8.13%	1.73%	8.81%

*The return figures are calculated using the redemption price 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. Returns of the Fund may include audited and un-audited results. Past performance is not a reliable indicator of future performance. ^^Inception date is 1 May 2019.

Month of June Attribution



Securities Underweight/Not Held



Source: Ellerston Capital.

In the month of June, the main positive contributors to the Fund's performance were its overweight positions in Bapcor (BAP +20.9%), GQG Partners (GQG +8.0%) Challenger (CGF +8.2%) and Insignia Financial (IFL +4.1%).

The detractors during the month were overweight positions in Ampol (ALD -6.9%), Perpetual (PPT -1.6%) and not owning any of the major banks (which collectively negatively impacted by 1.1%).

We re-visit and re-state our investment case on Bapcor (BAP +20.9%)

Bapcor (BAP), which caused us major grief last month, was the largest contributor to the Fund's performance in June after Bain Capital lobbed an unsolicited A\$5.40 per share conditional, non-binding cash takeover offer for the embattled company. The stock rallied in response, but is still trading well below the terms, with a lot of water to go under the bridge.

A string of missteps, earnings downgrades and management departures had tarnished investor perceptions. Yet, there is little to suggest that the core Burson business or broader automotive category is broken. The bid followed several profit downgrades from the company (the most recent in May 2024) and a 26.5% fall in the share price last month. The bid implies a 17.4x PER on consensus downgraded FY25 numbers, with the market forecasting improving earnings momentum into FY25 compared to the current 2H24 run-rate. This is premised on near-term cost out opportunities, notably corporate costs (blow out in HR, outside consultant costs etc) which have risen from ~\$26m in FY23 to an annualized ~\$43m in 1H24, coupled with the ineffective cost investment associated with the ill-fated Better Than Before program (BTB). However, as previously discussed, finding the right senior leadership team will be critical and the recent appointment of a credible CFO (George Saoud) is a step in the right direction. Assuming BAP can return margins to the average trailing 5yr NPAT margin of ~7% on consensus FY26 revenue of \$2,180m, this implies the current \$5.40 bid multiple is ~12x PER (which is far too cheap).

We had previously highlighted BAP's downgrades had been driven primarily by poor management decisions (under former CEO Noel Meehan who was removed) and ineffective BTB investment that did not yield the revenue benefits expected by an overly truculent management team (which arguably also impacted day to day performance). This was compounded by a much softer retail environment for the retail Autobarn business, moderation in the pace of price increases put through to customers and sticky underlying cost inflation on CODB. We observe that better managed businesses/offshore peers generate much higher margins. Key offshore aftermarket auto comps which BAP is benchmarked against include the likes of O'Reilly (ORLY), AutoZone (AZO) and GPC (Repco) in the US. These stocks currently trade on FY25 PERs of 21x, 17x and 13x respectively, but importantly, generate much higher EBIT margins (estimated at ~16% in FY24e vs BAP's at 9%), while also generating materially higher return on capital. Given a weak consumer, the PER multiples for these global peers have not surprisingly de-rated from their March 24 peaks (which averaged ~20x).

We are keeping faith and believe the shares are totally mis-priced at current levels. Our positive view and initial investment in BAP was predicated on compelling valuation metrics for a quality business operating within a favourable industry structure, with the expectation that a new management and a revitalised Board would execute a turnaround strategy. BAP is currently a damaged, but not a broken good business, but is now in play as a takeover target, so let's wait and see. The bid comes at an opportunistic time where management execution has been suboptimal, noting the company is yet to find a permanent CEO and new chair (with the current chairperson stepping down at the next AGM). Perfect timing for a suitor to swoop....

Financial Year 2024 in Review

In FY24, the S&P/ASX 200 Accumulation Index returned +12.1%, with most of the gains driven by PE expansion (+10.8%), offset by a 3.0% drag from earnings, mainly downgrades for Resources. Dividends contributed the balance to total returns (+4.3%).

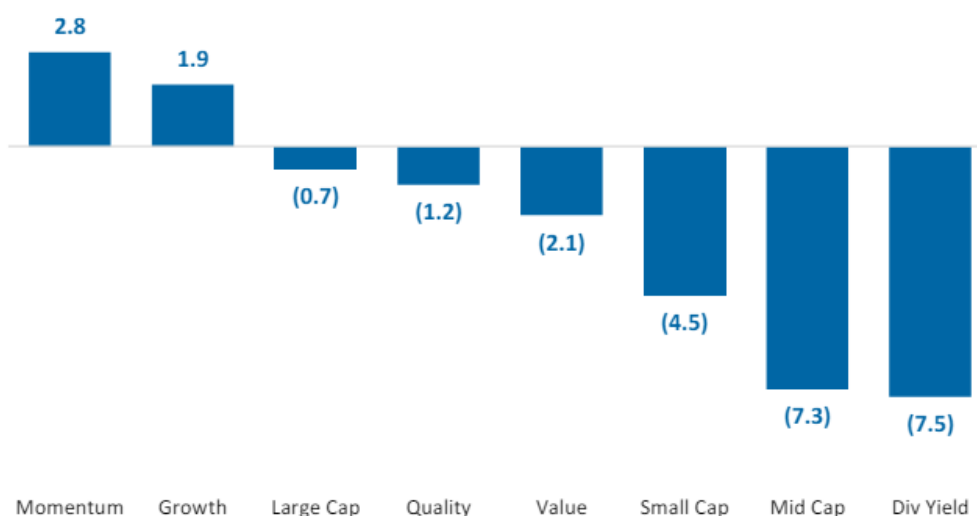
Banks were the clear sector winner, returning 34.9% and dividends (+6.9%) aside, the return for banks was almost entirely due to PE expansion (+30.0%), as forward earnings expectations actually fell by 2.2%.

Defensive sectors Telecoms (-10.4%) and Staples (-9.3%) were the worst performers, with both negatively impacted by a series of earnings downgrades and PE compression.

Over the last year, Momentum as a factor, significantly outperformed (+4.9%) vs Value, as investors had more confidence in growth and were positioned for expected rate cuts (which did not eventuate), yet rotated into stocks that worked. High Dividend Yield was the worst factor (7.5%), underperforming the market.

These drivers, including our bias to Mid Caps, have not suited our approach at all during the year.

Relative Factor Returns FY2024 – TSR relative to MSCI AC World



Source: Macquarie Research

FUND ACTIVITY

The Fund took profits in Challenger, GrainCorp and Suncorp and re-introduced Telstra given the recent sell off in the shares, as well as exiting its remnant position in Insurance Australia Group. We also strengthened recent acquisition Orora, as well as adding to Bapcor, soon after BAP successfully completed its debt refinancing (see detailed write-up in the Performance section), which removed a key balance sheet risk. The position in Atlas Arteria was also strengthened into the French election driven security price weakness, after having taken profits in the name by selling into IFM's creep on ALX at premium prices last month.

NEW STOCKS ADDED

- Telstra Group

STOCKS EXITED

- Insurance Australia Group

INCREASED

- Atlas Arteria
- Bapcor
- Orora

DECREASED

- Challenger
- GrainCorp
- Suncorp Group

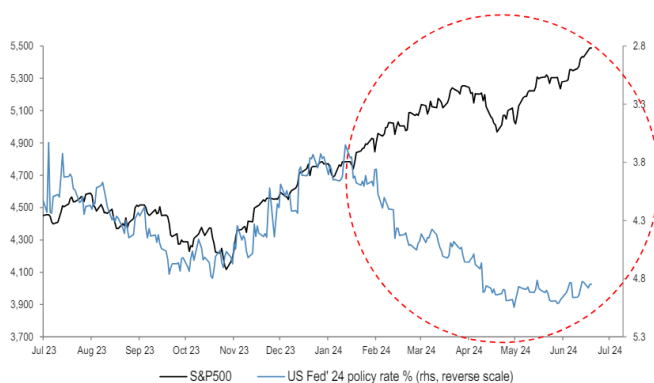
FUND STRATEGY AND OUTLOOK

Global growth continues to moderate from its robust 2023 pace, but the world is becoming less dependent on US demand as ROW capital expenditure and European consumers begin to pick up the slack. These developments are generating a modest recovery in global manufacturing. Inflation looks like it will remain sticky and persist given tight labour markets and elevated wage gains limiting service sector disinflation. This paints the picture of a shallower easing cycle which has already started in Canada and the EU, with markets pricing in a cut by the US Fed in November. A robust jobs market and a surprisingly resilient consumer has tempered recessionary concerns.

Unlike the start of this year when equities enjoyed the improving economic activity backdrop, reinforced by expectations of a series of Fed cuts, the second half of the year sees the Growth-Policy trade-off set to worsen. Fed easing projections have been unwound, but equity markets have shrugged this off, hoping that the growth in earnings will close the gap. Indeed, consensus forecasts are projecting a 15% S&P500 EPS acceleration between Q1 and Q4 of this year, double the norm. A combination of low unemployment, reasonable economic growth and the view that whilst inflation remains sticky, it has peaked, bodes well for the expected soft landing to play out and earnings growth to be delivered. There is of course the risk of disappointments – a lot is riding on AI.

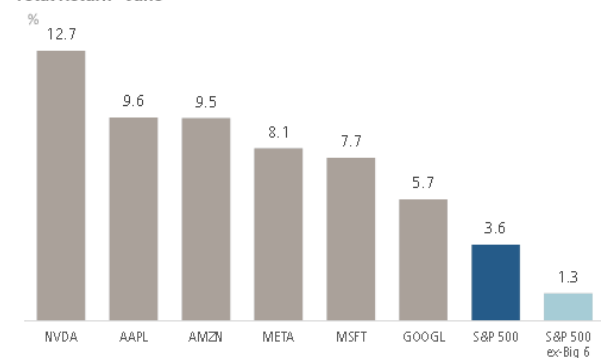
In the US, so far 2024 has been a year of two halves. In 1Q, expanding multiples drove strong returns across all major benchmarks, with modest profit gains outside of TECH+ stocks. In 2Q, by contrast, EPS improvements were more pronounced, but multiples broadly contracted outside of Big 6 TECH+ companies. The S&P 500 returned 3.9% (ex-dividends). The largest 6 TECH+ stocks were up 17.0% on strong EPS (+9.2%) and multiple expansion (+7.2%). The rest of the index declined -1.1%, on contracting P/Es (-3.8%). The Russell 2000 fell -3.6% as small cap companies experienced a significant improvement in profits (+6.2%); however, P/Es declined -9.2%, more than any other benchmark.

Fed Funds Futures vs S&P500



Source: JP Morgan

Total Return – June



Source: UBS

Closer to home, key data points are conflicting, but channel checks and recent company updates are showing that the real economy continues to cool. This is out of step with the minutes from the RBA's June policy decision, which discussed the stronger data since their May meeting, particularly on consumption and inflation. The RBA's view of the data remains somewhat cautious, discounting areas of strength and highlighting downside risks in the labour market and accelerating business insolvencies. A rate rise was considered but "the collective data received since the May meeting had not been sufficient to change their assessment that inflation would return to target by 2026, despite some elevated upside risk around the forecast". The recent data since the June meeting, particularly the May CPI print, has certainly landed to the high side of expectations, with the inflation narrative skewing to the more hawkish. Whilst maintaining the cash rate at 4.35%, the RBA noted that returning inflation to the target was unlikely to be smooth. Cash futures are now pricing in a 45% chance of a 25bps rate hike to 4.60% at the next RBA meeting to be convened in early August.

An interest rate rise would be a major blow to an already tepid economy and fragile consumer and hence, the RBA is more likely stay on hold through 2024, with easing starting in early 2025 (but it's anyone's guess).

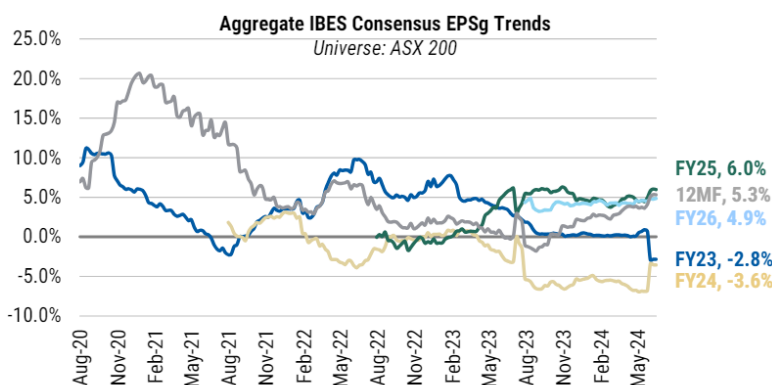
In terms of Valuations, the domestic market 12MF P/E currently stands at 16.4x. Outer year earnings growth forecasts remain fairly anchored in very low-single-digit territory.

The 12M forward PE of the Industrials ex- Financials has Fallen from 30.2x to 22.8x



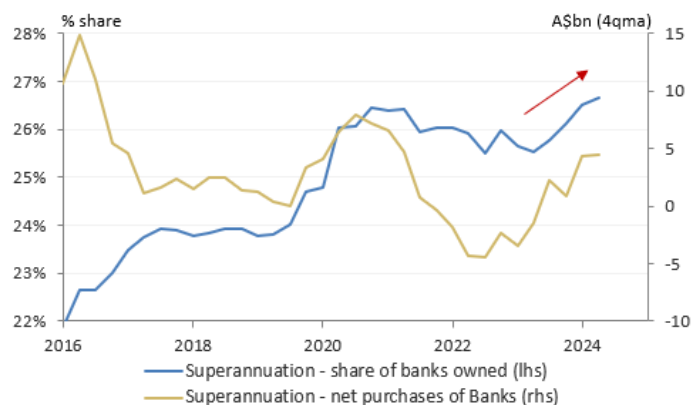
Source: Morgan Stanley

Annual Consensus EPS Growth Trends FY23-26



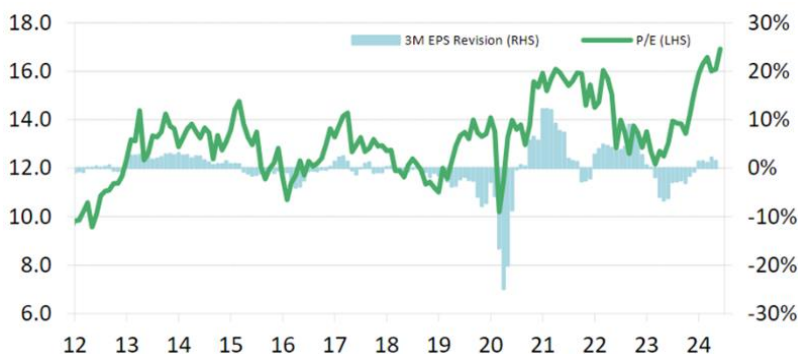
It has been a bewildering year from a performance perspective given our selectively contrarian Value and Ex-Top 20 size bias, which during the period, has remained out of favour in a market still chasing Big Caps, Tech, Growth, FOMO and Momentum. Whilst we have been able to navigate around those factors many times before, the performance by the major banks of +34.9% in FY24, of which +30.0% was from PE expansion, despite earnings downgrades and valuations looking stretched, is a hard pill to swallow and incredibly frustrating. That said, we have no intention of buying the Banks up here for the sake of neutralising any benchmark risk (it's just not the way we roll). We have added to existing holdings where our conviction in their outlook has strengthened and are confident that the major core positions in the portfolio will deliver and when coupled with the expected bank reversion, should more than compensate in FY25.

Superfund share of banks owned rose to record highs of ~26.5% (blue line). Net purchases also held at an elevated level (yellow line).



Source: MSR

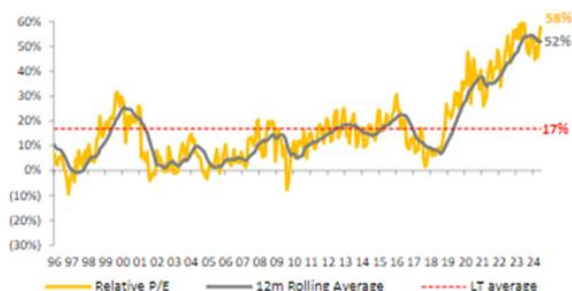
Major Banks: Average Consensus EPS Revisions and 1-yr Forward P/E Multiple



Source: Refinitiv, Morgan Stanley Research

CBA is now trading with an ~58% premium to peers and an ~8% premium to the All Industrials ex Banks.

CBA: One-year Forward P/E Premium/(Discount) vs. Peer Average



Source: Refinitiv, Morgan Stanley Research

One-year Forward P/E Multiple vs. All Industrials ex Banks



Given the geo-political risks (key parts of Europe tilting to the right, Middle East, China's military aspirations in the South Pacific etc) and uncertainty re the US election outcome/leadership and given that the risk-free rate has increased substantially, against the backdrop of sticky inflation and equities flirting with all-time highs, the risk of another unforeseen destabilising event for markets is high. Stay tuned.

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

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