

Ellerston Asian Investments Limited (ASX:EAI)

Performance Report | March 2020

PERFORMANCE SUMMARY

Performance	1 Month	3 Months	6 Months	1 Year	CYTD	Since Inception (p.a.)
Net [^]	-7.41%	-5.65%	2.77%	4.18%	-5.65%	5.98%
Benchmark*	-7.56%	-6.52%	-0.07%	-2.00%	-6.52%	6.43%
Alpha	0.15%	0.87%	2.84%	6.18%	0.87%	-0.45%

Source: Ellerston Capital

[^] The net return figure is calculated before all tax provisions, after fees & expenses, includes the effects of the share buyback, and excluding the effects of option exercise dilution. Past performance is not a reliable indication of future performance

*MSCI Asia ex Japan (non-accumulation) (AUD)

PORTFOLIO COMMENTARY

March was one of the most volatile months since the GFC. Ellerston Asian Investments (EAI) ended the month of March down 7.41% and outperformed the benchmark by 0.15% (net). Year to date in calendar 2020, EAI is down 5.65% and has outperformed the benchmark by 0.87% (net). In addition to outperforming our Asian benchmark, EAI's returns CYTD are significantly higher than the returns in the domestic market, with the ASX 200 down 21.2% during March and the ASX Small Ords down 22.8%.

During March, Ellerston Asian Investments paid an interim dividend of 1.5 cents per share. The dividend profit reserve as of March 31, 2020 was \$7.6 million which is equivalent to a fully franked dividend of 5.73 cents per share.

To help investors understand how the portfolio is performing during these volatile times, we continue to disclose daily NTAs. The pre-tax NTA as at March 31, 2020 was \$1.1214. The most recent daily pre-tax NTA (April 9th) was \$1.1301.

Comparing daily NTAs to changes in our benchmark, reveals that as of April 9, 2020, absolute performance month to date in April is positive and relative performance also remains above benchmark (gross). We are pleased that we have been able to deliver positive alpha in both the violent down markets (March) and during the rebound (April month to date).

EAI's absolute returns in 2020 have outperformed the returns of the ASX 200 and many other developed markets (DM). This is due to Asian markets as a whole outperforming developed markets and also because EAI has outperformed our benchmark.

There are a number of key reasons why many Asian markets outperformed many developed markets during March:

- FIFO (First In First Out):** Many Asian countries (China, Korea, Taiwan) were among the first countries to enter the epidemic curve and therefore are the first countries to start to recover and normalize economically. While Chinese markets corrected at the end of January and early February due to COVID-19 risks, global markets, the US in particular, didn't sell off until over a month later.
- Performance Post GFC:** Asian markets had been under pressure from the trade war for about 2 years prior to the outbreak of COVID-19. As a result, valuations were already very reasonable and there was less far to fall to reach oversold territory.
- Weak AUD:** The fall in the AUD from over \$0.70 at the end of 2019 to a low of \$0.57 on March 19th, provided an FX tailwind in March. The AUD has since recovered to above \$0.60 but, given the macro situation in Australia and the current stance of the RBA, we do not expect the currency to rebound to above \$0.70.
- Oil:** Asia as a region has very few countries that are net oil exporters (Malaysia is the exception) and Energy is less than a 4% benchmark weight in MSCI Asia ex Japan. In early March when the oil price fell sharply in one day, countries/regions with lower energy weightings outperformed.

Key Facts

Listing Date	4 September 2015
NTA (before tax)*	\$1.1214
NTA (after realised tax)[^]	\$1.1214
NTA (after tax)**	\$1.1091
Share Price at 31/03/20	0.92
EAI Market Capitalisation	\$122.3 Million
Average Management Fee	0.83%
Performance Fee	15%

* NTA (before tax) – Includes taxes that have been paid.

[^] NTA (after realised tax) - Includes a provision for tax on realised gains from the Company's Investment Portfolio.

** NTA (after tax) - Includes any tax on unrealised gains and deferred tax.

EAI's outperformance versus our Asian benchmark can be attributed to a few factors:

1. **High Cash:** At certain times during March we were at 20% cash but this had reduced to 9.3% by the end of the month as we invested in high quality oversold stocks going into month end.
2. **Large cap bias:** The MSCI Asia ex Japan Index outperformed the MSCI Asia ex Japan Small Cap Index by over 6% in March alone. As we have stated many times, large cap stocks in Asia offer better risk reward as they have higher returns and lower liquidity risk. This was definitely true in March when many smaller cap stocks dropped both due to worsening fundamentals and also due to forced selling and low liquidity.
3. **Oil:** Due to our strict growth and ESG criteria, EAI's portfolio is generally underweight the Energy sector. We had no upstream energy exposure in March and only held 1 stock with exposure to the energy complex, Reliance Industries, which is an Indian conglomerate comprising of telecom, retail, petrochemical and oil refining assets. Our zero weight in upstream oil stocks added to alpha during March.
4. **Stock Picking:** When I worked at Oaktree Capital, Founder and CIO Howard Marks was fond of saying "*Avoid the losers and the winners will take care of themselves.*" This was certainly true in March where a number of our largest single stock contributors to alpha were not owned. These include Axis Bank, Bajaj Finance and CNOOC. Stocks that we do own that contributed to alpha are JD (a potential beneficiary of lock down conditions) and Hindustan Unilever (staples).

While the above explains performance and market movements in March, the question on every investor's mind is whether global markets bottomed in March and when economies will begin to normalize. Our view is that different markets are going to bottom at different times and that the path of economic recovery is going to differ significantly across markets.

To help answer these questions and guide our thinking on country allocation and cash balance during this volatile time, we have developed a proprietary COVID Market Matrix. The criteria we consider for the matrix includes:

1. COVID-19 – Have infections peaked? Have deaths peaked? Is lockdown over or nearing the end?
2. Policy response – Has there been monetary stimulus? Fiscal? What % of GDP is the fiscal stimulus? Is the policy response adequate?
3. Valuations – Are P/B multiples near GFC lows? Are downward EPS revisions adequate?
4. Technicals – Which markets are oversold technically? Which markets are at or near strong technical support levels?
5. Flows – Have retail investors capitulated? Are local governments providing direct market support?
6. Oil Price – Is the country/market a beneficiary of lower oil?

Each country in our universe is given a score on each of these criteria and then countries are ranked, best to worst, based on their total score. Currently China is ranked #1 as it is furthest along the epidemic curve, the policy response is adequate, valuations are attractive, the "national team" has provided market support (particularly A shares) and China is a net oil importer.

Surprisingly, many ASEAN countries also ranked high in late March because the epidemic is/was not in exponential growth phase, P/B valuations were at or below GFC levels and technical indicators were showing extreme oversold levels. As such we added to ASEAN in late March and early April, primarily in Thailand and Indonesia.

The country that ranks the worst on our COVID Market Matrix is Malaysia because it is in total lock down despite having a relatively benign epidemic curve, the policy response has been inadequate (fiscal stimulus of 1.2% of GDP), valuations and technicals are not showing extreme levels and Malaysia is the only country in Asia that is a major oil exporter. We have no exposure to Malaysia in the portfolio.

We also rank the major developed countries in the matrix as well and the US and Europe fare worse than most Asian countries. We have long espoused the idea that Emerging Markets in Asia have more policy optionality than Developed Markets globally and this continues to be the case. Despite most countries in Asia lowering interest rates during COVID-19, no country is close to the lower bound. By contrast, the US, Europe, Australia and Japan are already at the lower bound and have to rely to QE and other unconventional stimulatory monetary tools.

Similarly on the fiscal side, except India (which has very little fiscal room to manoeuvre without risking a credit rating downgrade) most Asian countries have fiscal positions that are relatively strong. Furthermore, unlike the US which remains wedded to a strong dollar policy and has a divided political landscape, Asian countries have currency and industrial policy options.

In late March the matrix was showing attractive buying opportunities in a number of Asian markets. As such, cash has gone from a peak of ~20% during the month to 9.3% at the end of March 31, 2020. One area where we added exposure was in India pharma. This sector has been unloved for many years as the US Food and Drug Administration (FDA) appeared to be on a veritable witch hunt to reduce exports of generic and some branded drugs from India (a less well known aspect of the trade war).

However, in a global pandemic where the US is now at the epicentre, inexpensive and high quality pharma products are suddenly a friend to the US not a foe. President Trump in particular has enthusiastically endorsed hydroxychloroquine as a possible treatment for COVID-19. One stock we bought in late March was Cadila, an Indian pharma company that has the 3rd largest market share of hydroxychloroquine (18%) in the US. Currently, the stock is up 29.2% since we initiated the position a few weeks ago. We also invested in SUN Pharma in late March and that investment is up 25.0% over the same time frame.

One sector where we are proceeding with caution is financials. While consumer facing sectors and technology may recover relatively quickly once economic activity normalizes, the wave of NPLs for banks could take multiple quarters to flow through earnings. We have trimmed exposure to financials and have done extensive model reviews of all our remaining financial holdings to ensure that dividends are sustainable and capital positions are strong. We continue to like China Merchants Bank, OCBC, Ping An and BBKA.

As you are aware, the Ellerston Asia team spends considerable time on the ground in Asia, typically around 1/3rd of the year. Interestingly, given restrictions on travel, the number of virtual conferences, Zoom calls and other forms of company engagement has rapidly replaced face to face meetings. As such, since January 2020 we have completed over 160 company contact points which is considerably higher than our company contact run-rate last year.

As always, if you have any questions regarding any aspect of EAI or the portfolio, please feel free to contact us at info@ellerstoncapital.com. We look forward to discussing current events and the outlook for Asia on our update conference call on April 16. For more details, please see our website. We trust that you and your families are safe and well during this difficult time.

Kind regards,

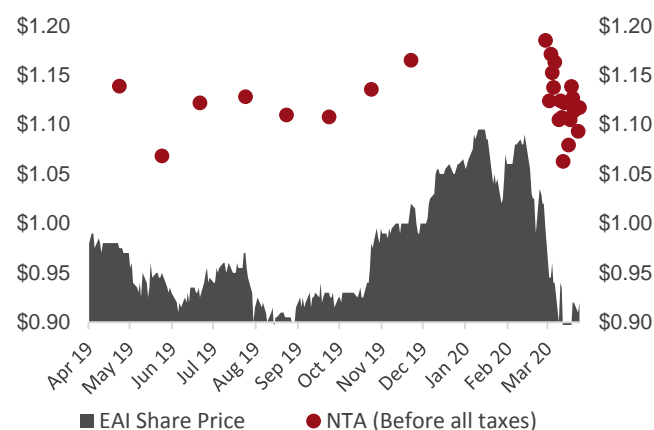
Mary Manning - Portfolio Manager

PORTFOLIO CHARACTERISTICS

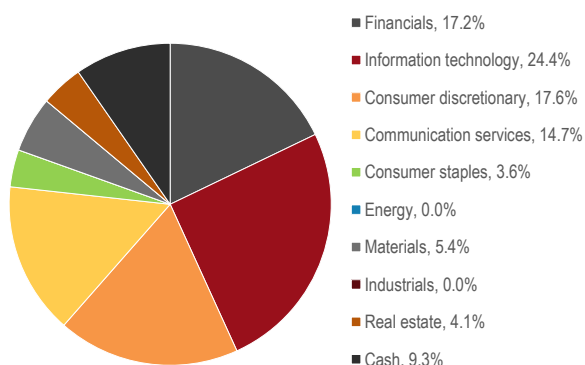
HOLDINGS

Top 10 holdings	%
Tencent Holdings Ltd	9.2%
TSMC	9.1%
Samsung Electronics	8.0%
Alibaba Group Holding Ltd	7.9%
Anhui Conch Cement Company Limited	4.4%
SK Hynix	4.2%
Sunac China Holdings	4.1%
JD.com	3.7%
China Merchants Bank Co. Ltd.	3.5%
Ping An Insurance	3.2%

EAI SHARE PRICE VS NTA

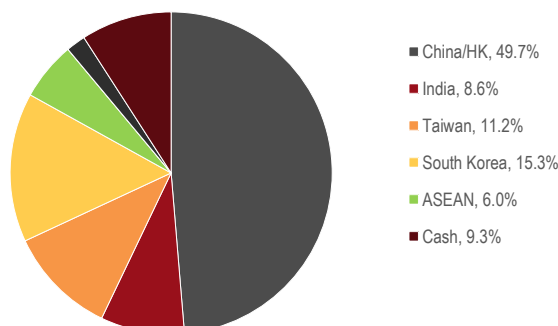


SECTOR ALLOCATION



Source: Ellerston Capital

GEOGRAPHIC ALLOCATION



All holding enquiries should be directed to our share registrar, [Link Market Services](https://linkmarketservices.com.au) on 1300 551 627 or EAI@linkmarketservices.com.au

Should investors have any questions or queries regarding the company, please contact our Investor Relations team on 02 9021 7701 or info@ellerstoncapital.com or visit us at <https://ellerstoncapital.com/>

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