Ellerston Asian Investments Limited (ASX: EAI)

Monthly Newsletter, September 2021

Key Information

Listing Date^^	4 September 2015
NTA (before tax)*	$1.2192
NTA (after realised tax)^	$1.1735
NTA (after tax)**	$1.1724
Share Price at 30/09/21	$1.10
EAI Market Capitalisation	$142.6 Million
Average Management Fee	0.82%
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.

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Performance Summary

Performance	1 Month	3 Months	6 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	Since Inception^^ (p.a.)
Net^	-3.04%	-7.91%	-3.41%	5.55%	9.91%	8.66%	7.29%
Benchmark*	-3.23%	-6.41%	-2.19%	11.57%	10.04%	6.98%	8.17%
Alpha	0.19%	-1.50%	-1.22%	-6.01%	-0.13%	1.68%	-0.88%

^ 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)

Ellerston Asian Investments (EAI) was down 3.04% (net) in September versus the MSCI Asia ex Japan Index which was down 3.23%.

EAI aims to have a sustainable dividend policy based on multiple years of profit reserves. On October 5, EAI paid a final dividend of 3 cents per share fully franked. The dividend profit reserve as at the end of September was approximately 13.4 cents per share (includes FY22 profits) and accounts for the cash set aside to fund the dividend payment.

September was an eventful month categorized by a number of market moving events including: (1) China slowdown and regulatory concerns; (2) imminent US Fed tapering; (3) COVID improvements; and (4) higher oil prices. We discuss these issues in detail below.

China Slowdown and Regulatory Concerns

China remained a key focus for investors during September with the potential collapse of Evergrande and widespread power outages adding to ongoing regulatory actions across a growing number of sectors. This has led to fears that China could experience a temporary period of stagflation. Indeed, we see a risk of higher energy driven inflation and slowing economic growth for China into year end. Historically, the prospect of an economic slowdown would increase the likelihood of policy stimulus. However, given China recorded GDP growth of +12.7%yoy in 1H21, policymakers can tolerate much slower growth in 2H21 and still meet the 'above 6% growth' target for 2021. We therefore remain tactically underweight China on these slowdown and regulatory concerns.

On the Evergrande situation, the potential collapse of the high profile property developer led to concerns this could be China's 'Lehman moment'. Evergrande's 800 unfinished projects across China, ~200,000 person strong workforce and US$300bn in liabilities has given the impression that it's potentially 'too big to fail'. But it's important to put these numbers into context. Evergrande represents only 2% of the total unfinished property projects in China and 0.2% of the country's labour force. Meanwhile, its liabilities is equivalent to only 2% of China's GDP and 0.6% of total banking system assets. Furthermore, ~95% of Evergrande's liabilities are owed to domestic lenders and suppliers. As such, the potential negative impacts to China's economy and global financial institutions appear to be manageable. We believe the most likely outcome is an orderly restructure of the company, which would involve asset sales to state firms and debt extension and write-offs. This would prevent any potential systematic risks given 90% of China's top 60 property developers currently comply with the government's 'three red lines' test for balance sheet health.

There may however be some short term spill over effects such as a hit to home buyer sentiment, tighter lending conditions and softer private consumption. EAI has very little direct exposure to the Chinese property sector outside of China Merchants Bank and Beijing Oriental Yuhong. A slowdown in economic growth however would present a greater short term risk to the portfolio and specifically to our domestic consumption names such as Li Ning, Alibaba and JD.com.

The other risk to China's economic growth outlook that emerged during the month was the power shortages impacting ~20 provinces across the country. The situation is a result of China falling behind in its carbon reduction plans for this year due to higher than expected output from energy intensive sectors such as metals, cement and chemicals. China's curbs on the production and import of coal have also slowed traditional thermal power production in recent weeks. In order to avoid social unrest, the Government will likely look to rectify the thermal power production situation and prioritise residential energy use. In order to accommodate this, high energy intensity 'old economy' sectors such as steel, aluminium, cement and glass will therefore need to cut production meaningfully in the coming months. Other energy intensive sectors such as auto, textiles and technology manufacturing could also be impacted. These production cuts are likely to result in higher domestic commodity and producer prices and this inflation is likely to be exported globally. We currently do not own any Chinese materials stocks and hold one Chinese automaker in our portfolio. As for our tech supply chain stocks, our channel checks suggest no impact so far for Samsung Electronics and Hon Hai's operations in China.

Finally regarding the ongoing regulatory crackdown in China, attention during the month turned to Macau and the cryptocurrency sectors. As regular readers would know, ESG is an important aspect of EAI. Gaming is considered a 'knock out' sector for the fund and we therefore have no exposure to the Macau names. Similarly, we have no direct exposure to cryptocurrency. Nonetheless, the broadening of regulatory focus suggests this issue is likely to remain a near term overhang for investors into China. Despite this, we continue to be structurally positive on the China internet names and believe many of these companies such as Alibaba are undervalued. We however also acknowledge 'cheap' valuations alone are an insufficient precondition for these stocks to rally. So in order for us to turn more positive on the sector and move more overweight, we need to see positive catalysts that signal this round of regulatory reform is coming to an end. These include the resumption of IPOs either domestically or offshore, M&A activity and new online games approvals. Until then, our China allocation continues to be weighted towards companies that operate in government promoted sectors.

US Fed Tapering

The US Federal Reserve at its September meeting hinted that a gradual scale back of its US$120bn/month bond buying program 'may soon be warranted' and guided to the potential for interest rates to rise by end 2022/early 2023. The US 10 year yield rose from a low of 1.28% during the month to 1.53%. This led to rotation away from growth sectors such as tech towards rate-sensitive sectors such as banks. We hold a number of banks that are beneficiaries of rising rates such as DBS, Shinhan Financial and Hang Seng Bank.

We have previously written about the risk of an equity market correction during the policy transition phase as investors adjust to a 'new normal' of lower liquidity and higher rates. This transition is likely to play out over the next 12-18 months. As such, we continue take a barbell approach to portfolio positioning by holding high quality, low beta growth stocks within the tech, healthcare and consumer staples sectors as well as rate sensitives such as financials.

COVID and Vaccines

There continues to be tangible signs of improvement in the COVID-19 situation across Asia with declining case numbers in all countries except for Singapore and South Korea and rising vaccination rates. Almost all Asian countries have now vaccinated over 20% of its population, with China/HK, Korea, Singapore and Malaysia at over 50%. Whilst these are clearly positive developments, the zero tolerance approach by many Governments across Asia remains a risk to the near term growth outlook for companies in those countries. Within Asia, we are overweight countries where the COVID situation is under control and where the Government has a more 'relaxed' approach to the virus such as India.

Another reason for our overweight positioning in India is the potential development of an oral antiviral drug for COVID-19. India is one of the biggest producers of pharmaceuticals in the world and is likely to play a prominent role in the manufacturing of such a drug. Merck is reportedly leading the race in the development of a COVID-19 pill (molnupiravir) and initial results from its phase 3 trial are very promising. If Merck can successfully get regulatory approval, the pill could be a 'game changer' in the fight against the virus, especially for the unvaccinated population. We have exposure to this development through our holdings in Divi's Labs, which is one of the largest active pharmaceutical ingredient producers (API) in India and is an authorized API supplier for molnupiravir.

Oil Prices

The oil price rose ~10% in September driven by concerns over potential supply shortages and higher demand. EAI currently has no direct exposure to the energy sector other than Reliance Industries, which is a conglomerate spanning telecom, retail, petrochemicals and refining. We however watch the oil price closely given our current overweight allocation to India, which is a net oil importer. A higher oil price is typically negative for India's current account balance and is a headwind for economic growth. But India's non-oil trade deficit has improved over the past few years and domestic consumption has anecdotally picked up in recent months. As such, we believe the overall macro impact from higher oil prices could prove to be more muted than in the past.

Portfolio Performance Attribution

South Korea and Hong Kong were the largest contributors to alpha during September. Whilst, China and India were the largest detractors. At a sector level, Consumer Staples was the largest contributor to alpha. Meanwhile, Consumer Discretionary and Materials were the worst performers. At a stock level, Reliance Industries and Kweichow Moutai were the biggest positive contributors to performance. The Reliance share price was boosted by continued market share gains in its Jio telecom business, expectations of a post COVID recovery in its retail business and earnings upside in its petrochemicals and refining divisions. Meanwhile, the new Chairman at Moutai provided a strategy update where he outlined a greater focus on direct to consumer sales, which could lead to better earnings growth. Conversely, Ganfeng Lithium and Li Ning were the biggest drags on performance. Li Ning was sold off on concerns of a consumption slowdown in China. Whilst Ganfeng Lithium saw profit taking from investor on concerns that the power restrictions in China would temporary impact production for its cathode customers.

As always, if you have any questions regarding any aspect of the Fund or the portfolio, please feel free to contact us at info@ellerstoncapital.com.

Kind regards,

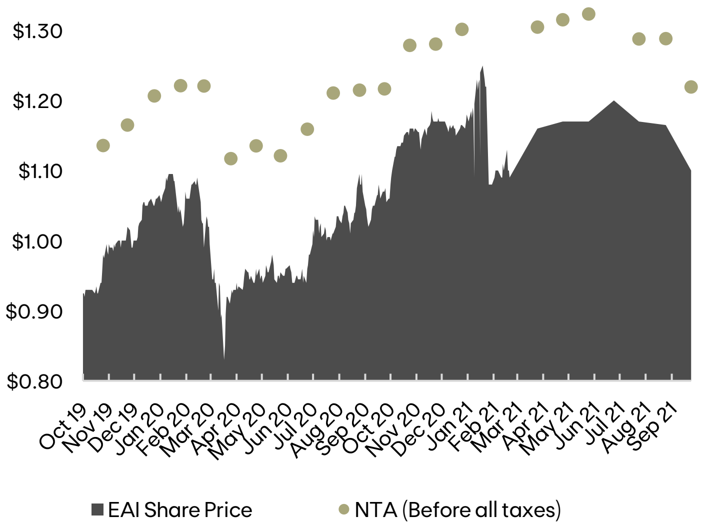
Fredy Hoh

PORTFOLIO CHARACTERISTICS

TOP 10 HOLDINGS

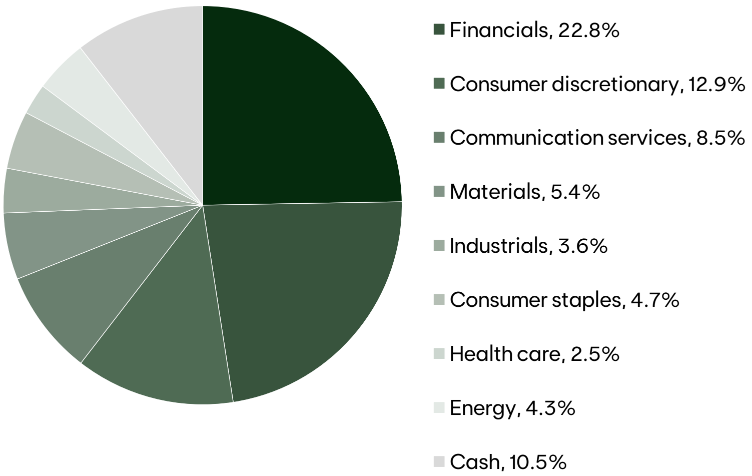
TSMC	10.2%
Samsung	5.6%
Alibaba	5.1%
Tencent	5.0%
Reliance Industries	4.3%
DBS Group Holdings	4.0%
Hong Kong Exchanges	3.0%
AIA Group	3.0%
China Mengniu Dairy Co	2.6%
MediaTek	2.3%

EAI SHARE PRICE VS NTA



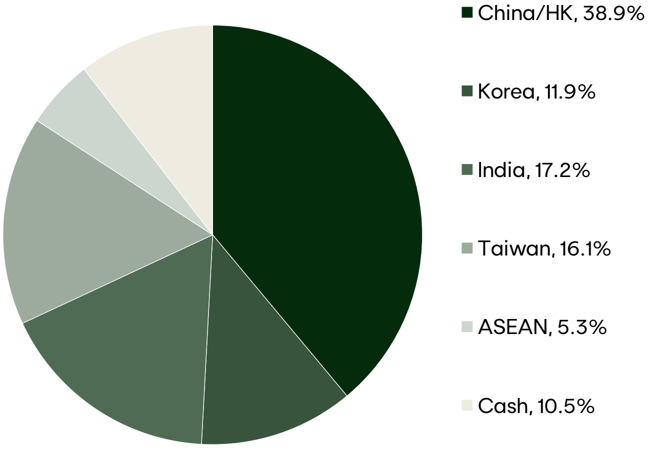
Source: Ellerston Capital.

SECTOR ALLOCATION



Source: Ellerston Capital.

GEOGRAPHIC ALLOCATION



Source: Ellerston Capital.

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Find out more

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

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