



# **Merlon Concentrated Value Strategy**

**Quarterly Report**

**December 2017**

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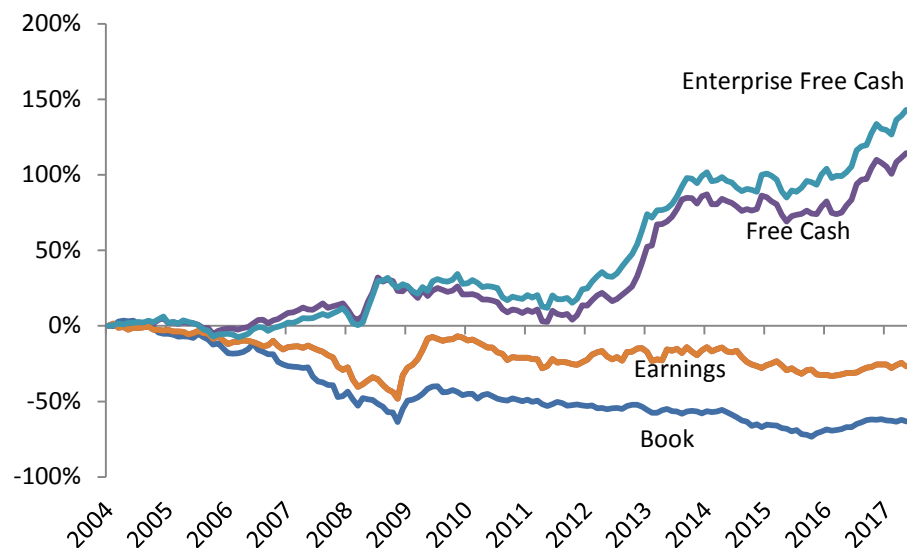
Value investing on the basis of free-cash-flow has performed well

## Value Investing – An Australian Perspective: Part III

While the long term returns from “value investing” are strong and well documented, the approach has struggled over the past decade prompting many investors to question its merits.

This paper represents the third of a three part series discussing value investing from an Australian perspective. In the [first paper](#) we concluded that value investing on the basis of free-cash-flow has performed well through a number of market cycles and has displayed low levels of volatility when compared to traditional classifications of value such as earnings, book value and dividends.

**Figure 1: Returns - “Value” Portfolios Relative to “Glamour” Portfolios (Australian Data, March 2004 to August 2017)**



Source: Merlon Capital Partners. Portfolios are formed using four valuation ratios: free-cash-flow-to-price (F/P); enterprise-free-cash-flow-to-enterprise-value (EF/EV); earnings-to-price (E/P) and book value-to-market (B/M). Portfolios are formed at the end of each month by sorting on one of the four ratios and then computing equally-weighted returns for the following month. The “value” portfolios contain firms in the top one third of a ratio and the “glamour” portfolios contain firms in the bottom third. The analysis is based on S&P/ASX200 constituents and the raw data is from Bloomberg.

In the [second paper](#), we began to explore the question of **why** value strategies based on free-cash-flow outperform the broader market. Consistent with our philosophy, we presented findings that show a linkage between value investing on the basis of free-cash-flow and earnings quality and went on to dismiss the notion that value investing is “riskier” than passive alternatives.

In this third paper, we discuss some behavioural biases in investor risk assessments and expectations. We also point to various elements of the Merlon investment process, structure and culture that are aimed at minimising our exposure to these biases.

## Misperceptions about risk

In our second paper of this series, we presented evidence that value investing on the basis of free-cash-flow in an Australian context is no “riskier” than passive alternatives. But if value strategies are not riskier than glamour strategies then only systematic errors by investors could account for outperformance. Systematic errors could relate to either:

- Misperceptions about risk; and/or  
(value stocks are perceived to be riskier than they actually are)
- Misperceptions about future cash flow.  
(growth prospects for value stocks are perceived to be worse than they actually are)

To exploit the outperformance of value stocks, any value investor needs to understand these biases and minimise them through investment process and firm culture.

As flagged earlier, the idea that value stocks are riskier is intuitively appealing given their unpopularity and high levels of perceived uncertainty. Investors might seek higher rates of return for owning these stocks to compensate for perceived higher risk profiles.

Empirical evidence such as that presented earlier suggests that investors should not be concerned about these risks at a portfolio level. That said, it is possible that in practice this is not the case<sup>1</sup>. Some examples of behavioural biases that cause misperceptions about risk are:

- **People are loss averse:** People are more sensitive to losses than gains.
- **The degree of loss aversion depends on prior gains and losses:** A loss that comes after prior gains is less painful than usual, because it is cushioned by those earlier gains. Conversely, a loss that comes after prior losses is more painful than usual.
- **People engage in narrow framing:** Loss aversion is applied to narrowly defined gains or losses (i.e. individual stock performance).

What this all implies is a discount rate for individual stocks that changes as a function of a stock’s past performance. If a stock has had good recent performance, the investor is less concerned about future losses and values the stock more highly. If a stock has performed poorly, the investor finds this more painful, becomes more sensitive to the possibility of further losses and discounts expected future cash flows at a higher rate.

At Merlon, we try to avoid this issue entirely by applying standardised discount rates for all stocks we cover. We also have a portfolio construction approach that, subject to rigorous peer review, is directly linked to analyst research output. This removes an element of subjective override that can be more prone to behavioural biases. That said, we need to be

*Known behavioural biases cause misperceptions about risk...*

*...with Merlon’s standardised valuation approach and research-driven portfolio seeking to avoid this issue*

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<sup>1</sup> See, for example: “Mental Accounting, Loss Aversion, and Individual Stock Returns”, N Barberis, M Huang – The Journal of Finance, 2001

constantly aware of areas where these biases might creep into our process and portfolios. Some examples are:

- **Loss aversion:** When we present sensitivity tables internally, all eyes and discussion immediately focus on the worst case outcome, sometimes with total disregard for the best case outcome or sometimes even the base case outcome. This focus becomes more pronounced when we are reviewing a stock that has lost money or where recent aggregate portfolio performance has been disappointing.
- **Narrow framing:** Narrow framing is often evident when we analyse stock attribution internally and when we present attribution to our clients. Discussions are dominated by stocks that have underperformed over sometimes very short periods of time even when the losses attributed to these stocks are small within the context of longer term portfolio performance and risk characteristics.

While much of the academic literature implies that individual investors are more exposed to these biases than institutions, in our experience these biases are often reinforced by institutional processes and cultures. For example:

- **Remuneration structures:** Analysts that are measured and remunerated with regard to the performance of a small number of stocks over a short time frame are hardwired to focus narrowly.
- **Reporting structures:** If individuals are more sensitive to losses than gains, then individuals under the close scrutiny of superiors and/or clients that are similarly inclined are even more likely to be emotionally sensitive to losses over gains.
- **Asymmetric consequences:** Emotional sensitivity aside, analysts might steer away from unpopular stocks simply because they are difficult to justify to clients and/or superiors. The consequence of losing money on such a position (i.e. losing a client, a promotion or your job) may be greater than losing a similar amount of money on a more popular stock.

At Merlon, we have a long term performance orientation and an extremely flat structure with a high degree of analyst responsibility and accountability. The portfolio is hard-wired to reflect analyst research output, subject to rigorous peer review and sensible risk constraints. Analysts are completely aligned with client outcomes and are financially rewarded based on total career performance at the firm rather than rolling shorter-term periods. We think it is inappropriate to measure performance over any period less than five years. This combines with our standardised valuation approach and a deep awareness of our vulnerabilities to minimise our exposure to these behavioural biases.

*Institutional factors can play a significant role in reinforcing behavioural biases...*

*...which Merlon seeks to address with a long term orientation and flat team structure*

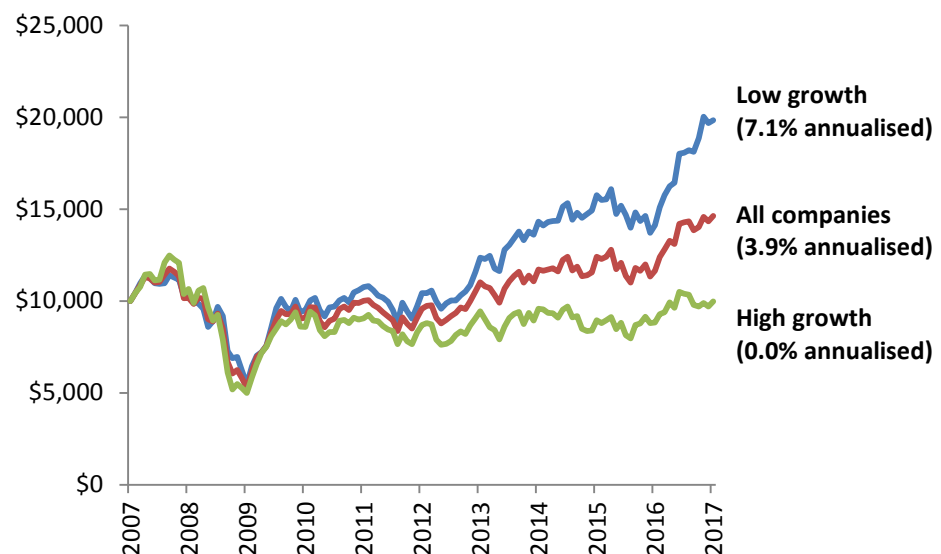
## Misperceptions about future cash flows

Risk considerations aside, it is possible that value strategies outperform because of misperceptions about future earnings and cash flows. We believe that one of the reasons the return differential between value and glamour stocks emerges is because investors extrapolate past growth rates too far into the future and put excessive weight on recent past history in forming predictions<sup>2</sup>.

To illustrate this phenomenon, we went back 10 years and sorted all ASX200 constituents according to their sales growth over the preceding five years. We placed higher weight on more recent sales to reflect investors' tendency to put more weight on short term results and divided sales by the number of shares on issue to adjust for companies that had grown revenues through acquisitions or heavy investment.

From this sorted list we created three portfolios representing companies ranking in the top third, middle third and bottom third for prior growth in sales. We rebalanced these portfolios on a monthly basis, adjusting index constituents and updating the sales growth calculations each time companies reported.

**Figure 5: Value of \$10,000 Invested in ASX200 Constituents, Feb-2007 to Feb 2017**



Source: Merlon Capital Partners. Portfolios are formed at the end of each month by sorting on growth in sales per share) over the prior 5 years weighted towards most recent year then computing equally-weighted returns for the following month. Raw data is from Bloomberg.

The results highlight that systematically purchasing stocks with deteriorating sales growth would have outperformed the market by around 3 percentage points per annum over the last decade and outperformed stocks with accelerating sales growth by around 7 percentage points per annum. These stocks are often the most difficult to justify to clients

<sup>2</sup> See, for example: "Contrarian Investment, Extrapolation and Risk", J Lakonishok, A Shleifer, R Vishny – The Journal of Finance, 1994

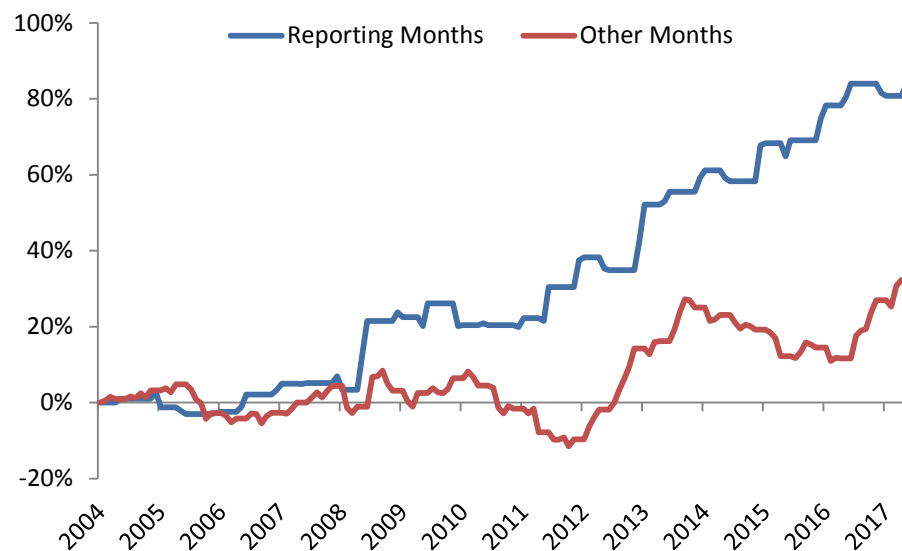
Investors have tended to extrapolate recent past growth trends too far into the future...

and marketing departments. It is for this reason that we believe this anomaly is likely to persist.

If investors form overly pessimistic (optimistic) expectations about future earnings prospects of value (glamour) stocks, then this would lead to subsequent price rises when these expectations are exceeded. Expectational errors are most likely to be realised following the release of public information such as earnings announcements.

Our analysis of recent Australian data supports this hypothesis. Of the annual average excess return of 7.1% of value stocks relative to glamour stocks, 4.7% was earned over the four months of the year when most companies report their interim and final results (February, March, August and September).

**Figure 6: Returns on “Value” Portfolios minus “Glamour” Portfolios (Apr-04 to August-17)**



Source: Merlon Capital Partners. Portfolios are formed using enterprise-free-cash-flow-to-enterprise-value (EF/EV). Portfolios are formed at the end of each month by sorting on one of the two ratios and then computing equally-weighted returns for the following month. The “value” portfolios contain firms in the top one third of a ratio and the “glamour” portfolios contain firms in the bottom third. Returns for each month are allocated to either “Reporting Months” (Feb, Mar, Aug, Sep) or “Other Months” (Jan, Apr, May, Jun, Jul, Oct, Nov, Dec). The analysis is based on S&P/ASX200 constituents and the raw data is from Bloomberg.

The tendency to extrapolate recent history in forming predictions is a common error in psychological experiments, not just the stock market, and could combine with a number of other behavioural traits to lead to overly pessimistic (optimistic) expectations about future earnings prospects of value (glamour) stocks. In particular:

- **Representativeness:** Individuals view a small number of events as “typical” and ignore the laws of probability in the process. Investors might classify some stocks as growth stocks based on a history of consistent earnings growth, ignoring the likelihood that there are very few companies that just keep growing.

Expectational errors tend to be realised during reporting periods...

Systematic errors in forecasting are also supported by known behavioural biases...

- **Overconfidence:** Individuals overestimate the precision of their assessments and in doing so strongly attribute events that confirm the validity of their actions to high ability, and events that disconfirm the action to external noise. This causes overreaction and momentum in security prices, but this momentum is eventually reversed as further public information gradually draws the price back towards fundamentals. This overconfidence is a form of **attribution bias**.

At Merlon, our peer review process is heavily skewed towards long term and factually based information. We generally seek a minimum of 10 years trading history when presenting a business with often much longer time series considered with regard to macroeconomic and other external cyclical influences.

### Concluding comments

The performance of value investing on the basis of free-cash-flow in an Australian context has been compelling and, in our view, represents a strong foundation for active stock selection. This key finding underpins Merlon's investment philosophy which is built around the notion that companies undervalued on the basis of free cash flow and franking will outperform over time.

Any investment philosophy needs to be supported by an understanding of **why** a particular approach is likely to generate excess returns. In this paper we highlight a number of well documented behavioural biases that are empirically and anecdotally evident in the Australian market.

We also point to various elements of the Merlon investment process, structure and culture that are aimed at minimising our exposure to these biases.

*Merlon's process, structure and culture is aimed at minimising our exposure to behavioural biases.*



**Analyst:**  
**Ben Goodwin**

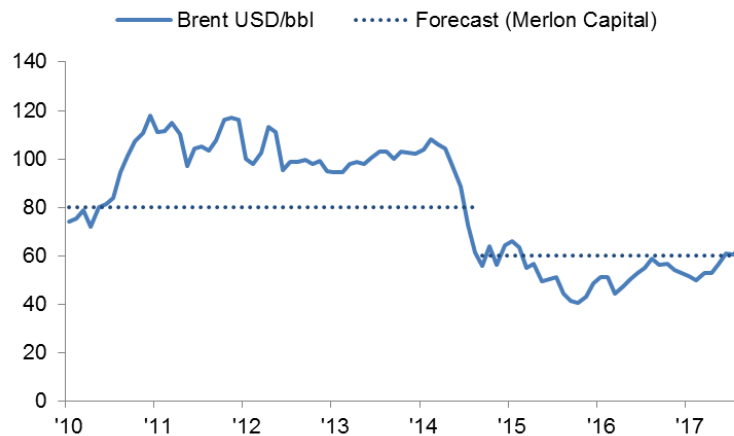


## Oil – The Cycle Continues

### Introduction

Over the period since Merlon's establishment in 2010, oil prices have traded between USD40 per barrel (bbl) and USD120/bbl, a period representing the end of an oil boom, and the beginning of an era of consolidation.

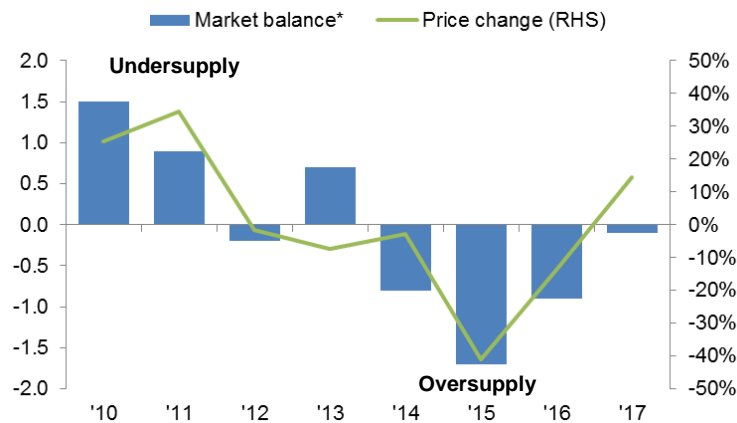
**Figure 7: Crude Oil Pricing**



Source: Bloomberg

This period has been characterised by two clear phases. The first, represented by USD100/bbl pricing, saw producers unable to keep pace with the growth in demand, and were incentivised by high prices to invest in new capacity. The second phase was the result of this investment in capacity, whereby the rapid increase in supply saw the market deficit reversed and pricing pushed to USD50/bbl.

**Figure 8: Market Balance – million barrels of oil per day (mbpd)**



Source: International Energy Agency \*Demand less supply (million barrels per day).

*Growth in demand ultimately beaten by growth in supply*

*Oil booms have been driven by technology (and capital) ...*

### Echoes of the past – the first oil boom

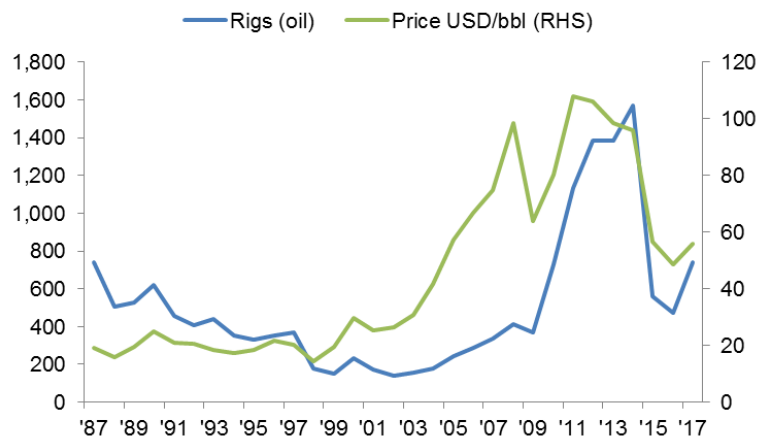
The original oil boom began in the United States in the 1850s. Like the shale oil boom witnessed recently, the boom was sparked by technology. Europe, in the 1800s boasted an oil industry but relied on digging by hand, which ensured the industry remained a small one. The crude oil was refined into kerosene and used in lamps.

In the US, the use of kerosene lamps also spread, enabling the effective extension of working hours and hence output per worker. In meeting the supply requirement for kerosene, entrepreneurial producers used drilling derricks originally designed for salt drilling and powered by a small steam engine. They then used a hand pump, originally designed for pumping bore water, to extract the oil.

### The new oil boom

Like the first oil boom, the last was premised on technology. The 2000s boom was initiated by the ability to drill in multiple directions (vertically down, and then horizontally outwards), coupled with the ability to fracture shale rock thousands of metres below the surface in order to stimulate the flow of oil and gas. It was this technological development, coupled with growth in the availability of capital through the effects of excess global liquidity that saw production surge.

**Figure 9: US Rig Count (oil)**



Source: Baker Hughes, Bloomberg.

### Come out swinging – a new swing producer

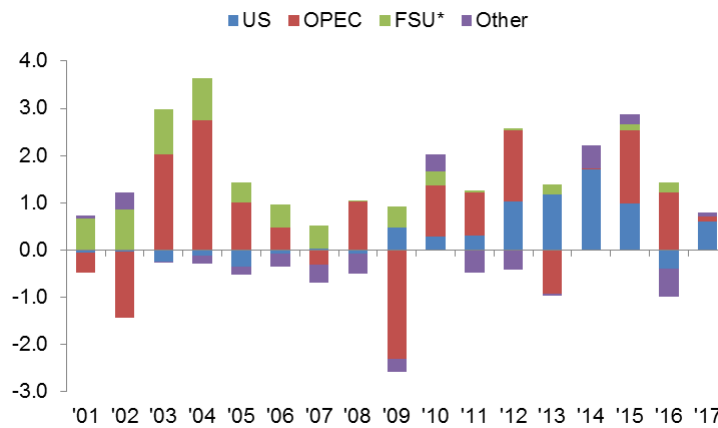
The proliferation of technology within the US oil and gas industry had effects broader than just on creating a surge of supply. The role of 'swing producer' - the producer actively seeking to keep the market in balance – has been held by Saudi Arabia, accounting for around a third of OPEC's production volumes.

The ability of shale's geology to significantly reduce the time to respond to market forces – turn the tap on and off so to speak - and deliver oil to market saw Saudi's role in the

*... with US shale oil changing the rules in recent times*

dominant market player diminished (see chart below). This reduced the Kingdom's ability to keep oil prices within an acceptable range and with it, the fiscal position of member states.

**Figure 10: Composition of Supply (mbpd)**



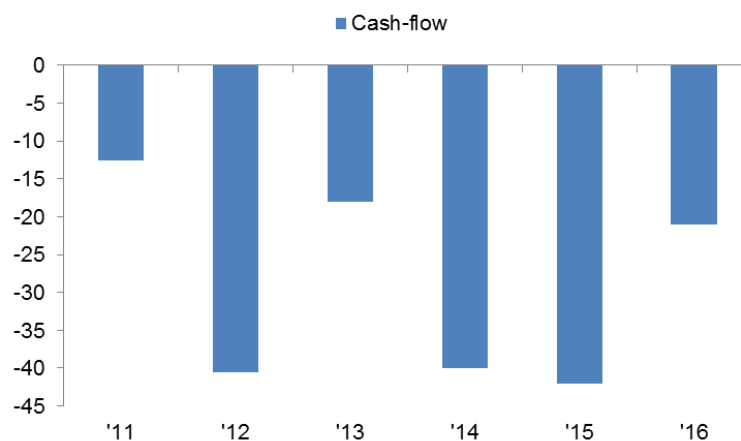
Source: BP / International Energy Agency. \* Former Soviet Union.

Where Saudi Arabia, in the form of its national producer - Saudi Aramco – is able to increase or decrease production significantly via a single decision from its oil minister, the United States production volumes are the result of hundreds of decisions of individual, public and private companies, motivated by the ability (or hope) to generate a return on capital invested. In this way we can see that Saudi actions are designed to ensure a stable price and end market, whereas US producer actions simply respond to price.

### But where is the cash?

US shale producers have been capitalised in the expectation of growing production and ultimately benefiting from higher prices in the future. However, collectively, the industry has lost a combined USD175b over the period 2011-2016, with the effect of their collective behaviour (reminiscent of the original oil boom) destroying prices and capital.

**Figure 11: Pre-tax Cash-flow of US Producers (USDb)**



Source: Bloomberg – sample of 48 listed leading US Exploration & Production companies.

*Capital has followed technology but returns have not followed capital...*

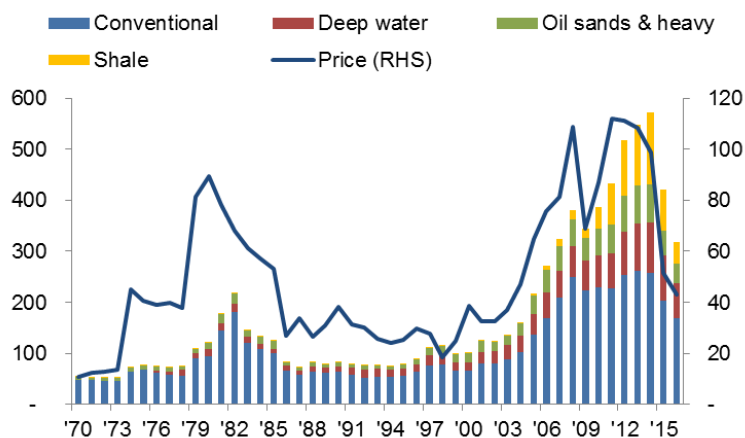
While the reduction in capital spending by shale producers is highly visible in terms of drilling activity as well as actual output, perhaps less visible is the effect on conventional oil field activity, which has seen capital expenditure nearly USD100b lower than the peak. The effect on output is far less visible as it is felt over the longer term. It is for this reason that longer term pricing is likely to be higher rather than lower.

... leading to cutbacks in spending despite ongoing depletion of reserves

### Capital expenditure slashed in the short-term

The chart below shows the effect of oil prices at ~USD50/bbl on capital expenditure. Capital expenditure on production capacity has more than halved from its 2014 level. This is important for oil production - continued investment is needed to offset the natural declines inherent in oil reservoirs. As the oil, gas and water is extracted from a reservoir, pressure depletes, reducing the flow of oil and gas. Capital expenditure is required to maintain pressure within the reservoir, as well as drilling additional wells, until the supply of economically extractable hydrocarbons is exhausted.

Figure 12: Capital Expenditure (USDb)



Source: International Monetary Fund.

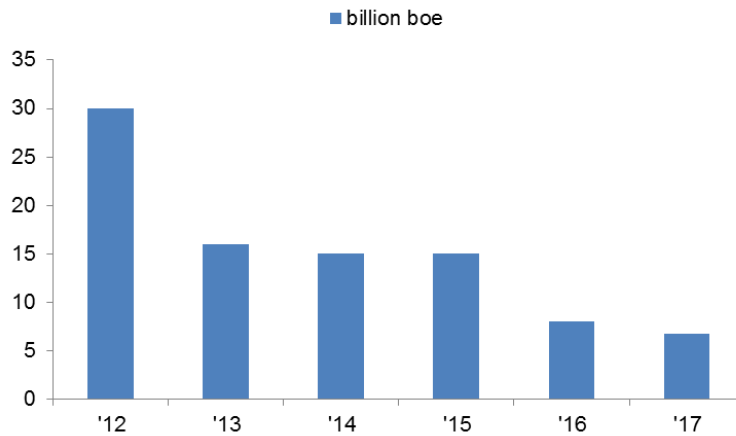
So how much do decline rates matter? The International Energy Agency calculated that for conventional oil fields, over the period between 1950 and 2012, oil output from existing wells declined by approximately six per cent each year. Applying this to current production would see 4.8mbpd of production lost each year. This figure is higher when factoring in the steeper decline rates of unconventional production in US onshore shale fields.

### Discovery – striking oil

We now see the early effects in terms of lower discovery success, a function of the amount of capital spent (as well as luck). According to Rystad Energy, 2017 oil and gas discoveries are likely to have been 7 billion barrels of oil equivalent. This represents a record low and perhaps of more concern, dominated by gas rather than oil components. The implication of this are that the ability to address decline rates noted above, as well as meeting continued

growth in demand of approximately 1-1.5mbpd. We turn now to this aspect, demand for oil and where the growth is coming from.

**Figure 13: Conventional Oil & Gas Discoveries**



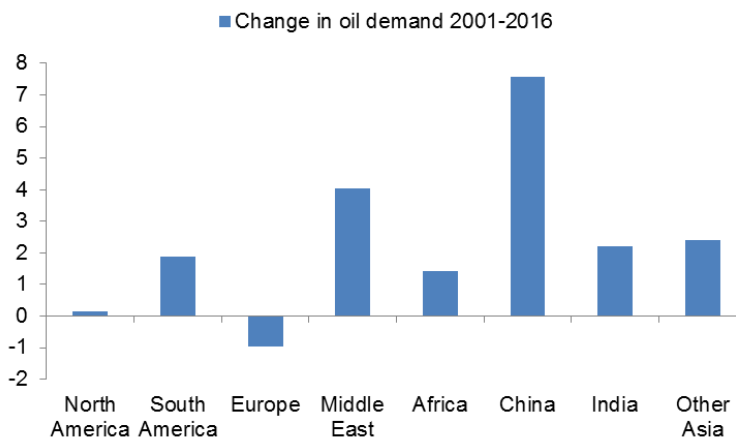
Source: Rystad Energy.

### Oil – who is buying it?

The predominant change in buyer behaviour since 2001 has been the growth in Chinese demand, while demand in the Middle East has also grown. Much of this Middle Eastern demand is through heavily subsidised transport fuel and though oil-fired electricity generation. In the context of stretched national budgets, the ability of Middle Eastern economies to continue consuming oil at such levels is arguable.

Less arguable is the growth in Chinese demand. While entry into the World Trade Organisation saw Chinese heavy industry consuming significant volumes of diesel for transport and factories, the next phase of development is likely to see significant growth in petrol and diesel products for consumers.

**Figure 14: Composition of Demand (mbpd)**

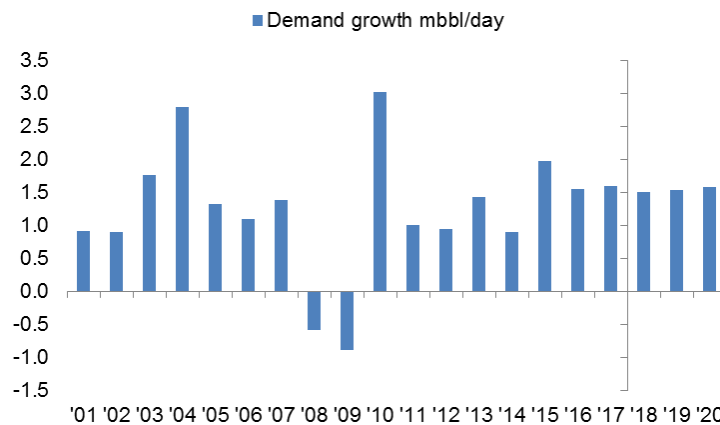


Source: BP.

*Chinese economic growth has demanded more oil ...*

Overall demand growth has averaged 1.2mbpd of additional demand each year. A third of this growth has come from China, which is significant, albeit far less so than its contribution to demand growth across other commodities, with China accounting for primarily all additional demand. Regardless, it is likely China will continue to play a dominant role in the profile of future oil demand growth, even if its investment-led economic model slows as we expect.

**Figure 15: Global Oil Demand Growth**

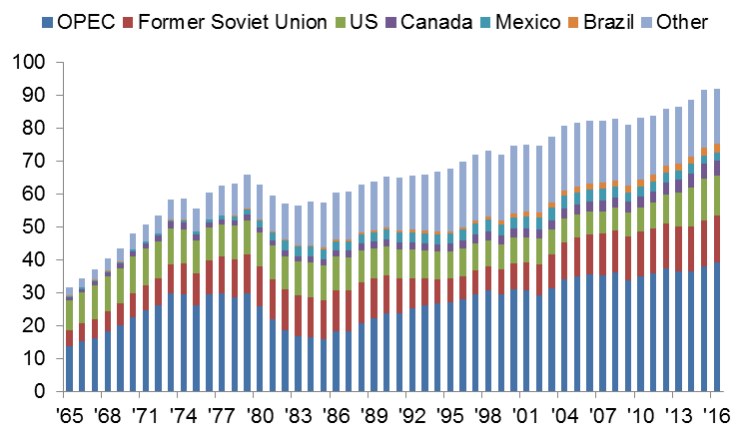


Source: International Energy Agency.

### Oil – who is selling it?

The key producer of oil globally is the organisation for oil exporting countries (OPEC), a 14-member production bloc founded in 1960, and dominated in terms of supply by Saudi Arabia. The second and third largest producers are Russia and the US. Of these OPEC remains the dominant production block, while the US is the most significant source of growth, accounting for more than half of the growth in supply over the past five years.

**Figure 16: Composition of Supply (mmbpd)**



Source: BP.

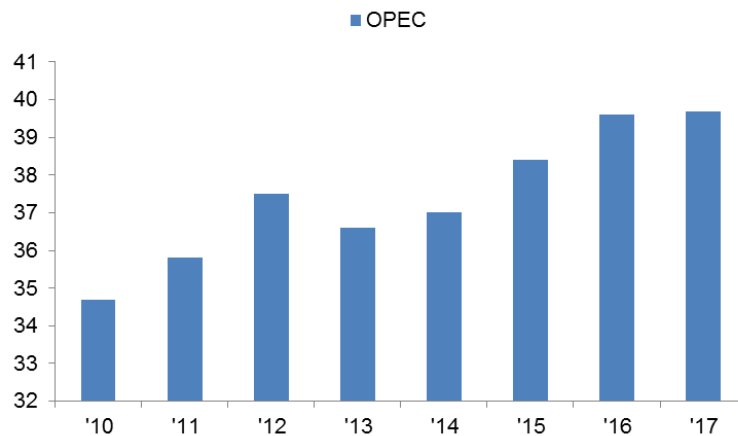
... with a more predictable demand profile than other commodities

**OPEC discipline is holding...**

We expect the OPEC-led coalition production agreement to restrict supply to be eased as the market surplus is absorbed. The agreement is to expire at the end of 2018, subject to an interim review schedule for June.

While the end of production restraint appears negative for oil pricing, the ambition of the Saudi government to sell a proportion of Saudi Aramco is likely to be supportive of OPEC discipline, potentially limiting the downside to pricing from radical changes to the current production agreement.

**Figure 17: OPEC Production Freeze (mbpd)**



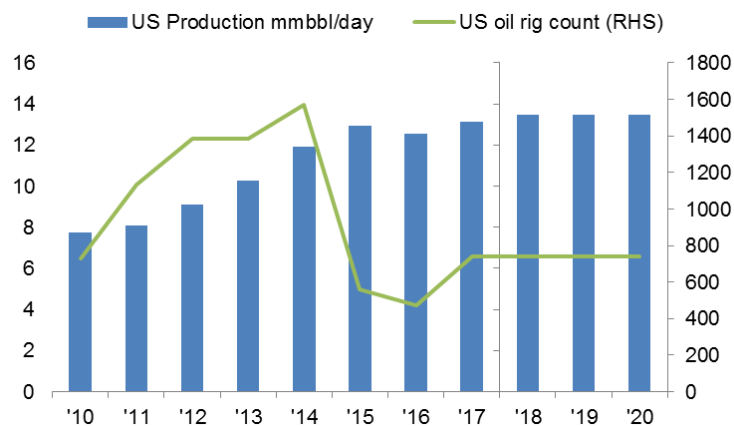
Source: International Energy Agency.

**...while US activity is coming back**

We also expect US onshore production growth to continue with more shale wells profitable at the current USD60-plus per barrel pricing, as shown in the cost curve (see below).

Current estimates suggest growth in US output of 0.5-1.0mbpd in 2018, accounting for much of the expected 1.0-1.5mbpd demand growth. Should production from the US spike more rapidly and favour nearby US producers, pressure would rise on the OPEC-led coalition policy to increase supply so as to not cede market share.

**Figure 18: US Activity (mbpd)**



Source: International Energy Agency.

**Increased rig count will have a lower impact on production**

Although US production growth could place downward pressure on prices, it is not certain that the effect of the rapid decline in rig activity has impacted supply as might be expected. In fact US production has been supported, despite rig count halving, by well completions. These completions are the result of a lag between when a well is drilled, and when it is fracked. Further, the productivity of the remaining wells being drilled is higher than those likely to be brought online, given the need to focus on the most productive regions when oil prices were low. And finally, as interest rates rise in the US, and elsewhere, the flow of capital into the sector is likely to diminish, reducing capital available for continued activity.

On a longer term basis, as the US industry consolidates and the less efficient producers exit, we will see the effects of a depleted opportunity set of conventional fields available for development, given the declining discovery rates detailed above. As such we will see the upper end of the cost curve come into play in setting prices.

### Conclusion

Pulling the above analyses together in the following summary table, we see what is likely to be a relatively tight market by 2020 across a range of scenarios.

**Figure 19: Market Balance (mbbl/day)**

Supply growth	Low case	Base case	High case
2017		98	
US	-3	0	1
OPEC	0	2	2
Other	-2	0	0
2020	92	100	101

Demand growth	Low case	Base case	High case
2017		98	
China	1	2	2
Other	3	3	3
2020	101	102	102

Supply less demand	-9	-2	-1
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Source: International Energy Agency.

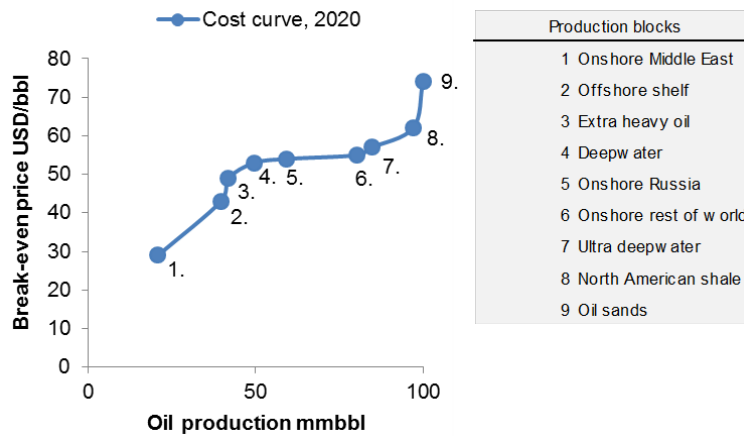
### Pricing

A tight market sees the upper end of the projected cost curve deliver pricing of USD60-70/bbl, which is in line with current pricing of USD65/bbl. However, we forecast this pricing even after factoring in the easing of OPEC-coalition supply restraints and assuming growth in US production.

**USD60-70bbl is required to meet modest demand growth assumptions**



**Figure 20: Cost Curve**



Source: International Monetary Fund / Rystad Energy.

### Fund positioning

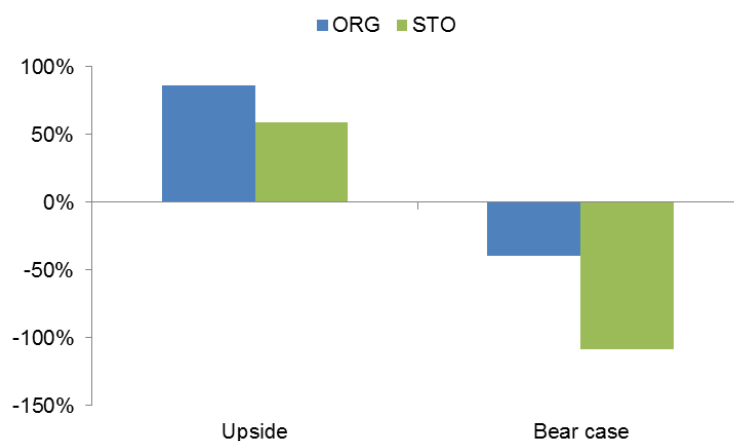
#### Energy producers

The majority of Australian energy companies are exposed to oil prices via liquefied natural gas (LNG) assets. LNG is ultra-cooled gas, which shrinks the volume and physical state (from gas to liquid) enabling the gas to be transported via ship rather than pipeline.

For Merlon to invest in an energy company, the proposition must display valuation upside, as well as limited downside losses. Although our recent track record has been good, forecasting oil prices is difficult and as such, we focus on a range of valuation outcomes at different prices, all based on sustainable free cash flow and deducting debt.

As an example, Origin Energy and Santos showed potential upside in early 2016 in the context of low oil prices and continued investment required to complete their LNG projects. However a key difference between the two companies was the margin of safety, as measured by our bear case valuation. This bear case showed far less risk to investing in Origin, despite low oil prices, and hence provided conviction to continue to invest in Origin.

**Figure 21: Managing Downside Risk (March 2016 scenarios)**



Source: Merlon.

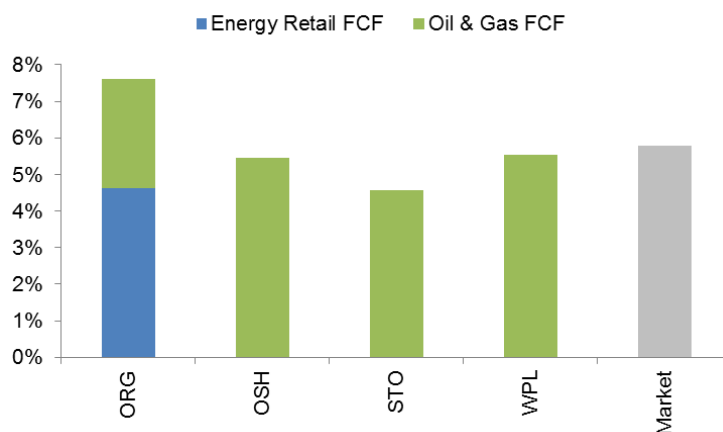
*The Merlon Fund is currently only invested in Origin Energy*

*Upside must be viewed in relation to potential downside.*

Where Santos is a pure upstream energy company, Origin also has a stable power generation and retailing business, which is less capital intensive than upstream gas extraction. When Origin was trading close to the value of its utility business in early 2016, the market was effectively valuing its upstream gas business as worth zero. This enabled Merlon to access the upside provided by the expectation of higher oil prices, without as much downside should this view fail to materialise. Merlon continues to hold Origin Energy across our portfolios.

Other potential investments in the sector included Woodside Energy and Oil Search. Woodside has a cash generative existing oil and gas business, however it has a declining production profile and is likely to become increasingly capital intensive as it seeks to address future production. Oil Search is similarly cash generative, however it is based in Papua New Guinea and hence does not generate franking credits. Further, it is similarly seeking new projects and will again see increased capital intensity.

**Figure 22: Sustainable Free Cash Flow & Franking Yield**



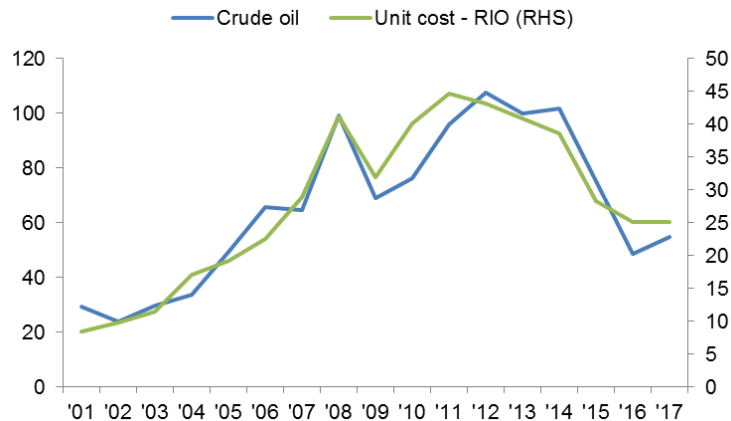
Source: Merlon. Undiscounted sustainable free cash flow and franking estimate divided by current market value plus projected net debt.

### Energy users

While producers of energy are obviously affected by oil prices, users of energy are also affected. Mining companies, for example, operate heavy industrial equipment and are highly energy intensive. Mapping Rio Tinto's iron ore division unit costs against oil prices shows this correlation. The key stock implication of this is that buoyant demand for iron ore allows miners to pass on higher unit costs but should demand moderate and / or supply growth exceed demand, operating margins will be crimped by the recent rise in oil.

**Can commodity producers retain enough pricing power to pass on higher oil prices?**

**Figure 23: Rio Tinto iron ore division unit costs vs crude oil prices**



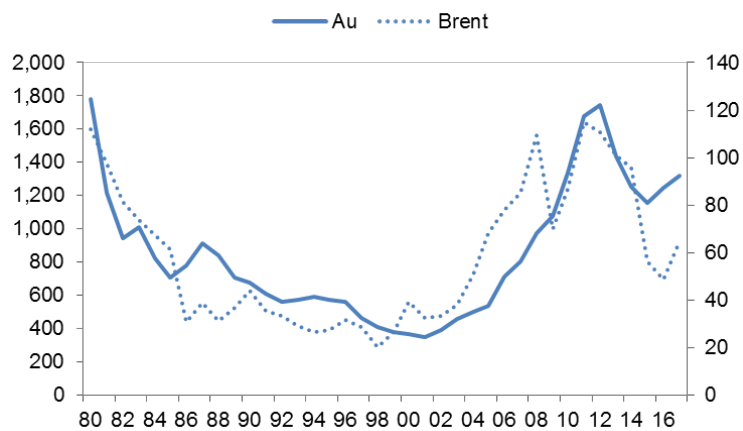
Source: Bloomberg. Merlon.

We model the effects of this in valuing the miners, and have no exposure to miners in the Fund. The effects of this have been unfavourable recently, however we expect the combination of softening industrial metals markets and tightening energy markets to combine to reduce unit cash returns of the miners, while increasing the profitability of energy producers.

**Inflation considerations**

As a final word, with energy prices a significant driver of inflation, it is useful to compare oil prices with the price of gold, the most common inflation hedge instrument. The chart below shows the strong correlation between these two price series. While it is reasonable to expect the rebound in oil prices to drive a rise in global inflation rates, gold prices appear to be more than factoring this rebound in. As such, Merlon has no exposure to gold exploration and production companies.

**Figure 24: Gold and Oil Price Comparison**



Source: Bloomberg.

*Gold looks overvalued as an inflation hedge*

Neil Margolis



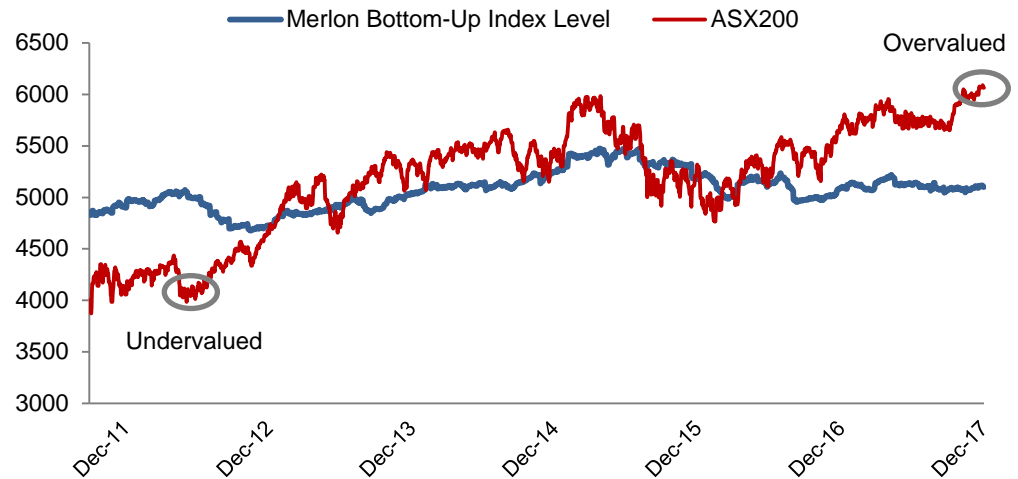
*Market more than 15% overvalued using consistent bottom-up approach...*

*However our value portfolio is showing upside in absolute terms and relative to the market*

## Market Outlook and Portfolio Positioning

Based on Merlon's bottom-up assessment of long-term cash-flow based value, discounted at through-cycle discount rates, the market remains more than 15% overvalued (Figure 25). There continues to be a wide dispersion across sectors, with resources, healthcare, property and infrastructure overvalued relative to other parts of the market.

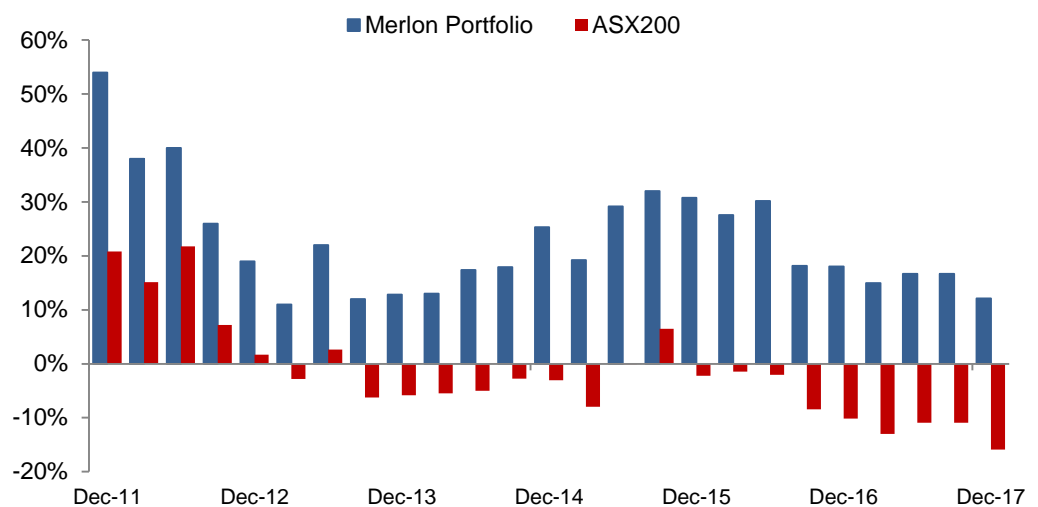
**Figure 25: Merlon bottom up market valuation vs ASX200 level**



Source: Merlon

Merlon's value portfolio comprises our best research ideas, based on our long-term valuations and analyst conviction. The portfolio continues to offer 12% absolute upside representing a 28% premium to the market. As seen in Figure 26, the Merlon portfolio is looking attractive relative to the capitalisation-weighted index.

**Figure 26: Expected return based on Merlon valuations**



Source: Merlon

We invest on the basis that, over time, interest rates will revert back to long term levels. This will put pressure on 'defensive yield' and 'bond proxy' names to which the portfolio has

relatively little exposure. Even if rates were to remain low, we would expect this to lead to a re-rating of our investments given their strong cash flow appeal.

The United States appears more progressed in the journey towards higher interest rates than Australia with increasingly clear signs of wage pressures and inflation. The Federal Reserve is likely to continue increasing interest rates over the next 12 to 18 months.

The divergent path of US and Australian interest rates coupled with our cautious outlook for commodities ([Some Thoughts on the Iron Ore Market](#)) lead us to expect depreciation in the Australian dollar. Our positions in **Magellan Financial**, **News Corporation**, **QBE Insurance**, **Origin Energy** and **Clydesdale Bank** should benefit against this backdrop.

A weaker Australian dollar will provide a necessary offset to housing construction activity and house prices that, at some point, will also revert back to mid-cycle levels ([Some Thoughts on Australian House Prices](#)). In conjunction with unprecedented strength in household balance sheets driven by recent house price inflation, the potential flex in the currency gives us some comfort that the outlook for the domestic economy, and by implication the discretionary retailers, may not be as bad as what is currently priced into the stocks. Further, after reviewing key differences between Australia and other markets, we believe the impact of Amazon is being overplayed and continue to see excellent value in the retail sector ([Amazon Not Introducing Internet to Australia](#)).

Our non-benchmark approach means we are content holding no **major banks** when the market is overly complacent about their risks and equally are happy to invest in them when the market is overly concerned – as is the case now. While political risks, such as the Royal Commission, cannot be ignored, we do not believe they will have a permanent impact on industry returns and cash flow generation. However, we do expect credit growth to slow, further loan repricing outside of a credit cycle to be limited and bad debts to rise towards mid-cycle levels. This leaves the banks as moderately undervalued in an expensive market.

### **Portfolio Aligned to Value Philosophy and Fundamental Research**

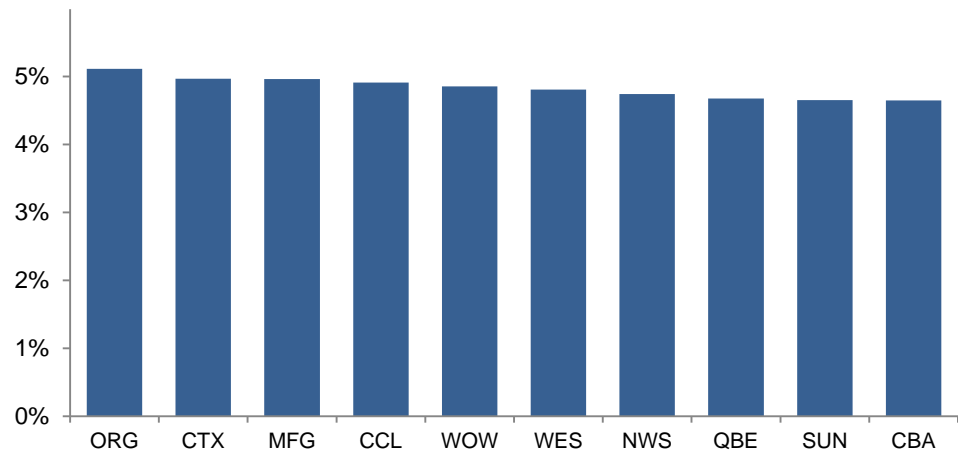
As we discuss above, there are clearly some macro themes built into the portfolio. However, these are outcomes of a strategy to invest in companies that are under-valued relative to their sustainable free cash flow and the franking credits they generate for their owners. The market's continued tendency to extrapolate short-term conditions too far into the future; participants' fear of forecasting a meaningful change in earnings power; and, investors' focus on nonsensical measures of corporate financial performance instead of cash flow continue to present us with opportunities.

The portfolio reflects our best bottom-up fundamental views rather than macro or sector-specific themes. These are usually companies that are under-earning on a three year view, or where cash generation and franking are being under-appreciated by the market.

*The outlook for the domestic economy is not as dire as many fear*

*The Fund invests in 'unloved' companies where sustainable cash flow is being under-appreciated*

**Figure 27: Top ten holdings (gross weights)**

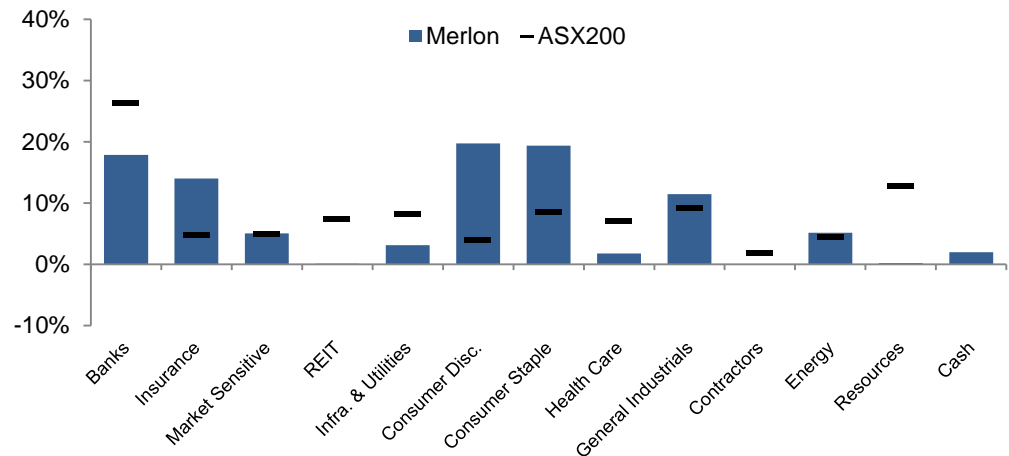


Source: Merlon

*The non-benchmark portfolio comprises only undervalued companies where we have conviction around market misperceptions*

Our larger investments are typically in companies 'unloved' by the market but current prices can be justified by the higher quality and more predictable parts of their businesses. **Origin Energy** is backed by its capital-light retail utility business; **Caltex** is shifting to lower capital intensity within an improving industry structure; **Coca Cola Amatil** has a growing Indonesian and domestic non-sugar drinks business with entrenched supply chain and refrigerated distribution advantages; **News Corporation** is shifting from advertising to digital subscriptions and has net cash on balance sheet; **QBE Insurance** has valuation support assuming minimal value outside of the domestic Australian and Lloyds businesses; **Suncorp's** insurance business is now under-earning despite increased industry concentration while the banking business is exposed to the higher returning retail segment; and **Commonwealth Bank's** leading retail franchise should continue to deliver sector leading returns despite short-term disruption from the money-laundering investigation. **Magellan Financial** generates strong and growing cash-flows with upside from performance fees, a debt-free balance sheet and USD-denominated FUM. The supermarket operators, **Woolworths** and **Wesfarmers**, are generating good cash-flows by competing rationally on convenience, range and value, not just price.

**Figure 28: Portfolio exposures by sector (gross weights)**



Source: Merlon

Some of our research ideas with the most valuation upside do not appear in the top 10 in terms of size as they are constrained by liquidity. These include, among others, **Seven West Media**, **Southern Cross Media**, **Virtus Health** and **Sky TV New Zealand**.

**Figure 29: Portfolio Analytics<sup>ii</sup>**

	Portfolio	ASX200
Number of Equity Positions	27	200
Active Share	75%	0%
Merlon Valuation Upside	12%	-16%
EV / EBITDA	9.1x	12.2x
Price / Earnings Ratio	15.6x	17.4x
Price / Book Ratio	3.0x	3.5x
Trailing Free Cash Flow Yield	5.5%	5.1%

Source: Merlon

## December Quarter Portfolio Activity

*We introduced new investments in Commonwealth Bank, Fairfax and Southern Cross Media*

During the quarter we introduced three new investments and exited two.

We invested in **Commonwealth Bank**, the leading Australian major bank in terms of main bank retail customer share and profitability. The retail franchise contributes more than 60% of earnings, and importantly for Merlon's approach, a greater proportion of free cash flow given lower mid-cycle loan losses and less required capital than business banking.

At an industry level, the market is concerned about high levels of household debt, reliance on offshore funding and increasing political and regulatory risk. Bad debts also remain well below mid-cycle levels but we factor reversion into our valuations. Further, the favourable industry structure in retail banking should mitigate political risks and presents upside risk to margins and returns, which are at historic lows following recent capital build.

CBA's status as the highest quality major bank has been undermined in the short-term by the fallout from recent money laundering breaches, including potential fines, higher costs, management distraction and a change in the highly regarded CEO. Ultimately we expect industry structure and CBA's leading retail franchise to outweigh any near-term disruption.

We reinvested in **Fairfax Media**, having sold a year ago during private equity takeover interest. Expectations for Domain, which comprises the majority of the valuation, have moderated a little, with the number two online real estate classified operator trading around fair value in an expensive market. This assumes market share and margins improve but do not match market leader Real Estate.com. Of more interest to us, the implied residual value of the legacy print, digital and radio assets is less than five times current cash-flow. We ascribe no value to metro print assets but do ascribe value to metro digital advertising, regional and NZ print and the radio assets.

We also reinvested in **Southern Cross Media**, owner and operator of regional and metro radio stations and regional TV through an affiliate arrangement with Channel Nine. The company is trading at more than a 50% discount to the average listed company based on Merlon's definition of free cash flow. This reflects market concerns of a structural decline in advertising outside of Google, Facebook and electronic billboards. In our view, these concerns are more than factored in, with mitigating factors including regional content and distribution being less exposed, metro radio margins being below history and peers, the variable cost structure of radio assets, improved Nine content and low levels of bank debt.

We added to existing investments in **Coca-Cola Amatil** and **Bendigo Bank**, both of which underperformed relative to our long-term cash-flow based valuations.

*Funded by exiting ANZ Bank and Bank of Queensland*

We funded these investments by selling our positions in **ANZ Bank** and **Bank of Queensland**, both of which had outperformed as market concerns around their higher risk profiles had dissipated.



Performance <sup>i</sup> (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)
Portfolio Return (inc. franking)	3.2	8.4	8.3	14.8	14.6	15.8	13.0
ASX200 Return (inc. franking)	1.8	7.9	9.1	13.2	10.1	11.7	9.8
<b>Excess Return*</b>	<b>1.3</b>	<b>0.5</b>	<b>-0.8</b>	<b>1.6</b>	<b>4.4</b>	<b>4.1</b>	<b>3.1</b>

\* Excess returns may not sum due to rounding, performance before fees.

## December Quarter Market Review

The market finished the year on a high, returning 7.9% (including franking) in the December quarter. US equities hit record highs as President Trump's tax cuts were legislated. The Australian dollar was broadly flat while commodities, including oil, rallied strongly. US long bond yields continued to rise, albeit modestly, but the US yield curve flattened as two year rates rose 0.4%. In contrast, Australian short rates were flat while ten year yields declined 0.2% back to June levels.

Not surprisingly, **Energy** and **Materials** were the best performing sectors, both posting comfortable double digit gains. **Consumer** stocks also outperformed as Amazon's launch underwhelmed and on expectations of positive Christmas spending. Defensive bond proxies and banks lagged the market but still posted positive returns.

## Portfolio Performance Review

The Concentrated Value Strategy returned 8.4% for the quarter, 0.5% ahead of the index mainly due to the benchmark unaware approach, with the major banks and Telstra limiting the market's return.

**News Corporation**, was the best performing portfolio holding after a strong 3Q result, a further rally in the REA share price and break-up speculation. **Origin Energy** outperformed on the back of strong oil prices as well as expectations of continued deleveraging. **Metcash** outperformed following its interim result, with the rate of decline in the grocery business slowing, growth in the hardware and liquor segments and a debt free balance sheet. **Navitas** outperformed on strong Australian university enrolment data and the re-signing of long-term contracts with university partners. Not owing **Qantas** rounded out the top 5 contributors in the quarter.

**Fletcher Building** was the biggest detractor after the company announced further contract losses and a change in CEO. Other detractors included **Westpac**, with major banks weighed down by the announced Royal Commission; **Virtus Health**, with continued competitive pressure from the lower priced Primary Healthcare offer; **TradeMe Group**, on concerns Amazon will one day enter the NZ market; and selling **BlueScope Steel** too early, as it continued to rally on cutbacks to Chinese steel production leading to firmer prices.

*The Strategy outperformed due to the non-benchmark approach and exposures to News Corporation, Origin Energy, Metcash & Navitas*

**But has slightly underperformed financial year to date**

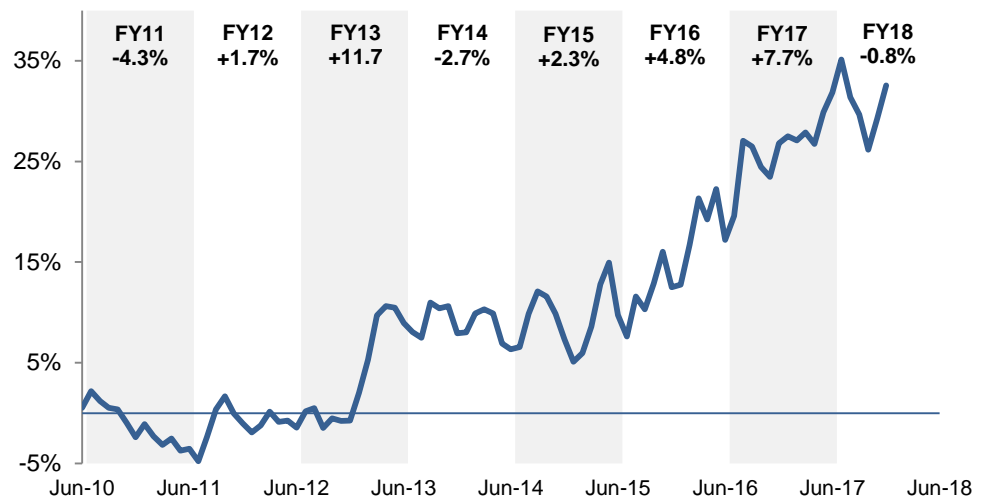
**Stock selection outcomes have been positive over longer-term periods**

Financial year to date, the Concentrated Value Strategy has underperformed the market by 0.8%. Again, the Strategy benefitted being benchmark unaware, with a tailwind from the mega large cap stocks limiting the market's return. On an equal-weight basis, the Strategy underperformed by more, with key detractors being **Fletcher Building, QBE Insurance, TradeMe Group, Magellan Financial, Suncorp** and not owning any mining stocks. On the other side of the ledger, **Origin Energy, Flight Centre, Metcash, News Corporation** and **Clydesdale Bank** contributed most positively to relative returns.

On a five year rolling basis, the Concentrated Value Strategy has outperformed by 4.1% per annum, with underlying stock selection of 1.9% per annum enhanced by a non-benchmark construction tailwind of 2.2%. We continue to hold the view there should not be any material deviation between the cap weighted and equal weighted index performance over longer time periods.

Performance contributors over the long term have been broad-based, with **National Australia Bank, Tabcorp, Pacific Brands, Macquarie Bank** and now owning **Arrium** and **Slater & Gordon** the key contributors. Key detractors over this time frame include **Woolworths, Seven West Media, QBE Insurance, Worley Parsons**, as well as not owning **Aristocrat**. At a sector level, owning minimal mining and energy stocks were the most notable contributors.

**Figure 30: Cumulative excess returns**



Source: Merlon

**Strategy FUM**

\$1,375.3m

**Merlon FUM**

\$1,668.7m

**About Merlon**

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Merlon Capital Partners is an Australian based fund manager established in May 2010. The business is majority owned by its five principals, with strategic partner Fidante Partners Limited providing business and operational support.

Merlon's **investment philosophy** is based on:

**Value:** We believe that stocks trading below fair value will outperform through time. We measure value by sustainable free cash flow yield. We view franking credits similarly to cash and takes a medium to long term view.

**Markets are mostly efficient:** We focus on understanding why cheap stocks are cheap, to be a good investment market concerns need to be priced in or invalid. We incorporate these aspects with a "conviction score"

**Links to Previous Research**

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[Iron Ore is Well Above Sustainable Levels](#)

[Boral's High Priced Acquisition of Headwaters](#)

[Some Thoughts on Australian House Prices](#)

[The Case for Fairfax Media Over REA Group](#)

[Value Investing - An Australian Perspective: Part I](#)

[Amazon Not Introducing Internet to Australia](#)

[Value Investing - An Australian Perspective: Part II](#)

[Telstra Revisited](#)

**Footnotes**

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**<sup>i</sup> Performance (%)**

Past performance is not a reliable indicator of future performance.

Strategy inception date for performance calculations is 31 May 2010.

Portfolio Total Return and S&P/ASX200 Accumulation Index Total Return stated before fees and grossed up for franking credits.

For the purposes of measuring total return, franking credits are calculated as franking credits accrued divided by the average daily NAV for the portfolio and benchmark.

**<sup>ii</sup> Portfolio Analytics**

Valuation upside based on Merlon estimates of sustainable free cash flow & franking credits.

Price earnings ratio based on Bloomberg consensus estimates over next 2 financial years, annualised & time weighted.

EPS growth based on annualised growth between last reported fiscal year and Bloomberg consensus EPS in 3 years' time.

Ex Ante Tracking Error calculated using 60 month volatility and correlation data.

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