Merlon Concentrated Value Strategy

Quarterly Report

June 2018

Contents

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Investors have taken on unnecessary risks given high demand for income, heightened sensitivity to capital loss and excessive bias to large cap equities

Rethinking Post Retirement Asset Allocation

Investors today face unique and significant challenges, especially in the post retirement phase.

Record low interest rates have heightened demand for income producing investments.

At the same time, the GFC still lingers in memory, with many investors under-exposed to growth assets and overweight defensive assets. This is despite the fact that, according to the ABS, the average life expectancy for a 65 year old woman and man to be 22 and 19 years respectively.

And within equities, there has been a rush to so called 'low vol' equities with little regard for valuation risk. To highlight this, while the overall PE ratio of the US market looks fair value relative to its post 1990 average, the PE ratio of the 100 least risky stocks in the S&P 500, as measured by share price volatility, is 44% above its long-term average. Expensive stocks in this category include infrastructure, property trusts and healthcare companies, among others. We wrote an in-depth paper on this topic in our March quarterly (Some thoughts on asset prices).

Another concern within equities is the rush to index funds, despite concentration risks such as large weightings to financials, miners or technology stocks. Furthermore, many investors hold direct shares also concentrated in the largest listed companies, creating double-up alongside index funds.

The out-working of all of this is many investors have taken on unnecessary risks, such as disregarding valuation, being overly concentrated and in some cases having insufficient exposure to growth assets.

With this backdrop, this paper examines 20 years of actual returns to present an alternative approach to generating sustainable income in post-retirement. This approach allocates a higher weighting to equities than typically considered and adopts a concentrated value approach rather than passive investing, all without taking on additional risk.

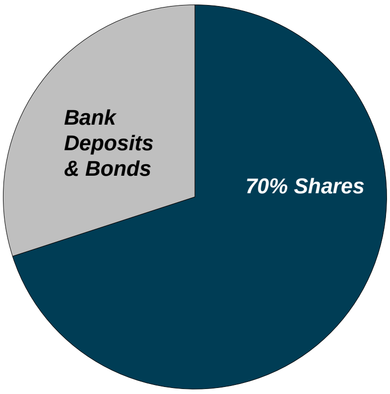
Accumulation strategies have delivered over the long term

During our working lives, investment strategies are typically aimed at accumulating wealth and are less concerned with year to year return fluctuations. During this phase – in order to maximise the final value of a portfolio – it usually makes sense to skew portfolios towards growth assets such as shares. While annual returns can be quite volatile, over longer term periods the volatility is less pronounced, particularly when inflation is taken into account.

The diagram below shows a typical asset allocation for an investor in the accumulation phase.

Accumulators have done well investing in growth assets over the past 20 years, provided they stayed the course

Figure 1: Typical asset allocation in accumulation phase



Actual 20 year return and risk outcomes	
Return	**= 8% pa**
Biggest drawdown	**= 45% (Oct-07 to Feb-09)**
Income	**= Not important**
Liquidity	**= Less important**

Source: Bloomberg, Merlon. Return & drawdown based on implementing strategy over 20 years to March 2018 and includes franking credits. Return on shares reflects equally weighted ASX100 constituents to April 2004 and equally weighted ASX200 thereafter. Return on bank deposits & bonds reflects 30 day bill returns.

Over the 20 year period between 1998 and 2018, an approach of holding 70% Australian shares and 30% cash would have provided an annual average return of around 8 per cent, beating inflation by around 5 per cent. This is a strong result and highlights the merits of allocating a substantial part of the portfolio to growth assets during the accumulation phase.

Investors needed to stay the course, however, as the largest drawdown was a 45% loss between October 2007 and February 2009, albeit an unrealised loss that was subsequently recovered provided investors rebalanced to maintain the target growth asset exposure.

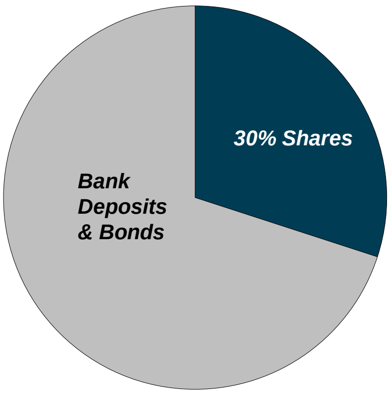
Traditional post retirement strategies fail to deliver sustainable income

In contrast, retirees need sustainable income and capital preservation

In contrast, retirees have different objectives – they need more income, can tolerate less risk and also need to preserve capital to ensure income streams keep pace with inflation. Such objectives can be conflicting with higher levels of income typically associated with higher risk and/or lower levels of capital return.

In practice, the growth-biased portfolio when accumulating wealth is more defensive in retirement, which we represent below as 30% Australian shares and 70% cash.

Figure 2: Traditional asset allocation in post-retirement phase



Actual 20 year return and risk outcomes	
Return	**= 6% pa**
Biggest drawdown	**= 18% (Oct-07 to Feb-09)**
Income	**= 7% pa growing at CPI**
Liquidity	**= More important**
Residual capital	**= 5% of initial investment**

Source: Bloomberg, Merlon. For methodology, see footnote to Figure 1

Over the past 20 years, our case study highlights the classic trade-off – returns reduced from 8% pa to 6% pa but the largest unrealised capital loss was 18% during the GFC.

The Holy Grail for retirees in an investment context is "sustainable income", which, in our view, means:

- The income lasts 20+ years in-line with life expectancy,
- the income grows with inflation each year, and
- most importantly, the capital is largely preserved at the end of the 20 year period.

A typical post retirement asset allocation would have failed to preserve capital over the past 20 years

To replicate a retiree's actual investment experience over the past 20 years, we withdrew $7,000 or 7% income from an initial $100,000 portfolio in 1998 and grew this income requirement by CPI each year. By the end of the 20 year period, the annual income requirement had increased to $11,800.

Because the actual yield of this asset allocation is less than 7%, retirees would have had no choice but to draw on their capital to supplement their income needs. The end result is only $5,000 or 5% of the original capital would have been preserved after 20 years, using actual returns experienced. This is illustrated in the chart below which highlights this typical approach would not have delivered "sustainable income" over the past 20 years.

Figure 3: Traditional post retirement asset allocation would not have preserved capital

Source: Bloomberg, Merlon. Return based on implementing strategy over 20 years to March 2018 and includes estimated franking credits. Traditional Asset Allocation represents 30% passive shares & 70% bank bills.

Low rates mean retirees need to consider a higher allocation to income producing growth assets

To make matters worse, the average interest rate used in this 20 year period was 4.4% but is only 1.8% at the current point in time while inflation is running at 1.9%.

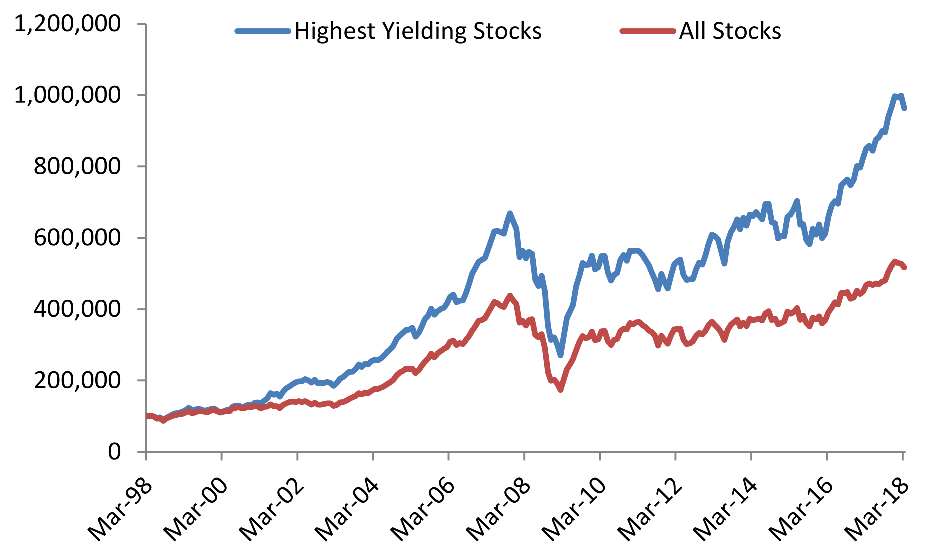
The key message from this analysis is investors should consider a higher exposure to income producing equities in a low rate environment.

Introducing a non-benchmark value investing approach

Extending our case study, we compared the performance of passively buying the 200 biggest stocks used in the previous analysis (represented in Figure 4 as 'All Stocks') with only buying the top third cheapest based on free cash flow yield ('Highest Yielding Stocks'). After all dividends are only sustainable if paid out of free cash flow.

This portfolio has outperformed handsomely relative to the passive strategy of buying all stocks, and generated superior yield and franking credits.

Figure 4: High Yield vs The Market – Value of $100,000



Source: Bloomberg, Merlon. Return based on implementing strategy over 20 years to March 2018 and includes estimated franking credits.

A non-benchmark value approach has generated superior returns and higher yield relative to passive share investing

We wrote several papers on this free cash flow based approach to value investing (Value Investing: An Australian perspective) which aligns with Merlon's value-based investment philosophy. The main difference of course is Merlon's fundamental approach focusing on sustainable free cash flow rather than the quantitative approach used in this analysis, which is based on last year's reported cash flow. The Merlon share portfolio is also more concentrated at 25-30 stocks compared to 60 used in this analysis.

The key message from this analysis is a non-benchmark value approach has generated superior returns to passive share investing.

But what about risk? Unrealised losses impact a retiree's financial well-being and lifestyle.

Overlaying downside protection while preserving fully franked income

Extending our case study further, we introduce a hedge overlay using derivatives to remove 30% exposure or risk while preserving 100% of the underlying dividends and franking credits from the share portfolio. This hedge overlay targets stock specific holdings at greater risk of short-term price declines using a tried and tested momentum strategy. This reduced the drawdown of the unhedged share portfolio by a third.

It is also possible to reduce risk within an equity strategy using derivatives, while preserving 100% of the income

This approach simulates the downside protection applied to Merlon's equity income strategy. In practice, and in this case study, we buy downside protection (or put options) on one third of the stocks, funded by selling the upside potential (call options) we don't think exists in the short-term. The call options reduce returns in stronger markets but, importantly, the put options protect capital in weaker markets.

The key message is it is possible to reduce risk within an equity portfolio using derivatives.

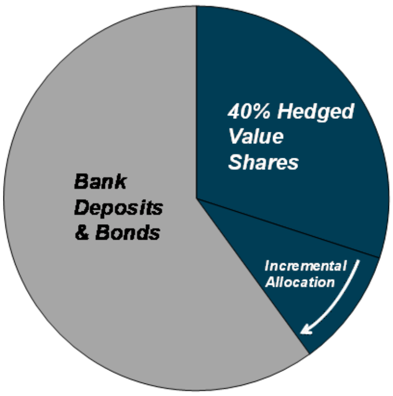
Pulling it together - equity income and post retirement asset allocation

Up to this point, our 20 year case study using actual returns between 1998 and 2018 has highlighted the need for more exposure to income producing equities and the benefits of a non-benchmark value investing approach with downside protection.

The final iteration of the case study incorporates a higher 40% weighting to hedged value shares (equity income) compared to the traditional 30% passive equities highlighted previously.

Introducing a higher allocation to hedged value shares (equity income) boosts sustainable income

Figure 5: Alternative asset allocation in post-retirement phase



Actual 20 year return and risk outcomes

Return	**= 8% pa**
Biggest drawdown	**= 14% (Oct-07 to Feb-09)**
Income	**= 7% pa growing at CPI**
Liquidity	**= More important**
Residual capital	**= 90% of initial investment**

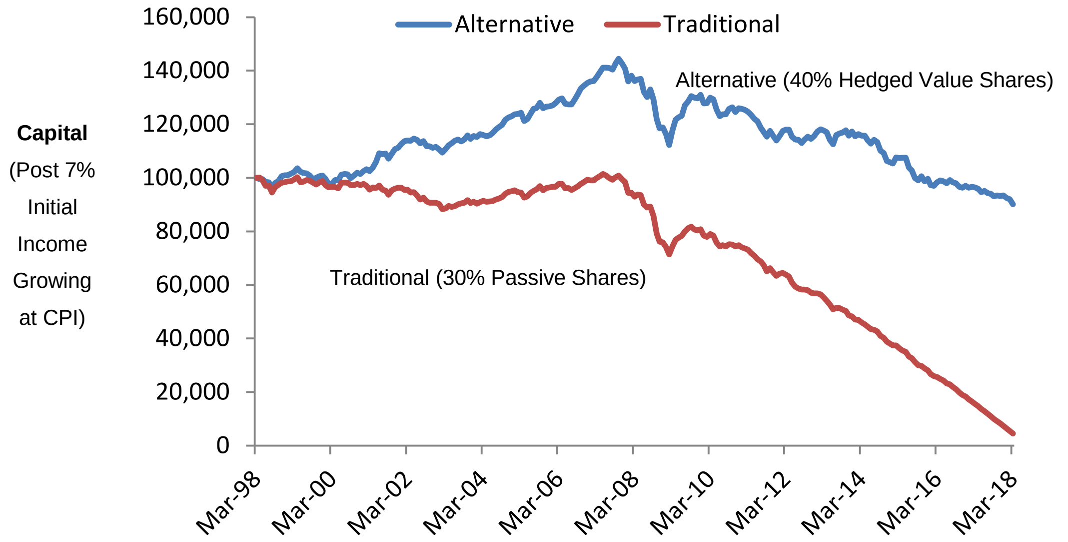
Source: Bloomberg, Merlon. Return & drawdown based on implementing strategy over 20 years to March 2018 and includes franking credits. Return on hedged shares reflects equally weighted portfolios of 30/60 ASX100/ASX200 constituents with highest dividend/free-cash-flow yields before/after April 2004 with equally weighted 'hedge' over 30/60 constituents with worst momentum characteristic representing 30% of portfolio. Return on bank deposits & bonds reflect 30 day bank bill returns.

The combination of a higher equity allocation and concentrated value outperformance delivered an 8% pa total return, matching the accumulation strategy despite having much lower equity exposure. Importantly, thanks to the 30% hedge overlay, the risk profile, as measured by maximum drawdown, was no worse than the traditional 30% equity allocation in post-retirement. Income is also boosted from the additional equities and tilt towards high yielding undervalued shares with additional franking credits.

After withdrawing the same or $7,000 initial income (7% yield) growing to 11,800 over 20 years, the traditional approach only preserved $5,000 of the initial $100,000 capital whereas the proposed alternative approach preserved $90,000. This capital preservation is consistent with the definition of sustainable income described earlier.

Sustainable income means capital is largely preserved

Figure 6: Capital preservation using alternative approach over the past 20 years



Source: Bloomberg, Merlon. Return over 20 years to March 2018 and includes franking credits.

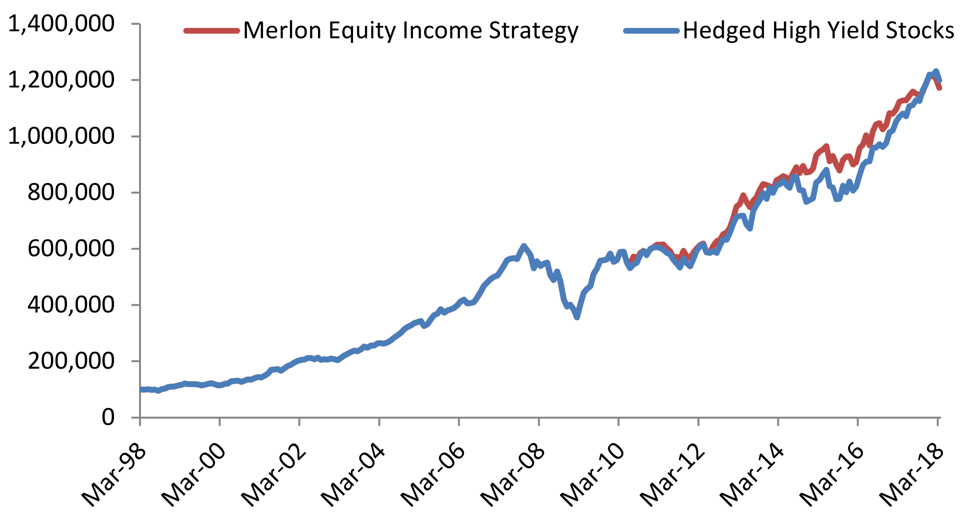
The key conclusion from this paper is to highlight the role equity income (defined as hedged value shares) should continue to play in post-retirement allocations. Modestly increasing the allocation to growth assets, tilting equities towards undervalued companies, generating valuable franking credits and managing risk through a hedging overlay, all combine to provide a more tailored investment approach for retirees' sustainable income needs.

Merlon approach aligned with case study

The chart below maps Merlon's equity income actual returns with the case study. It highlights similar returns, as expected given Merlon's cash-flow based value philosophy, benchmark unaware approach and 30% hedge overlay to deliver sustainable income.

The case study is consistent with Merlon's approach to equity income

Figure 7: Merlon Australian Share Income Fund vs "Hedged Shares" Portfolio



Source: Bloomberg, Merlon. Merlon Equity Income Fund return reflects period from May 2010 (Merlon inception) to March 2018, (includes franking credits and excludes fees).

Analyst:
Adrian Lemme

Amazon Revisited – Muted Impact So Far

There has been no bigger retail story over the last 12 months than Amazon's entry into the Australian market. This time last year we gave our initial view (Amazon Not Introducing Internet to Australia) on how Amazon will impact the Australian retail landscape with particular focus on ASX listed retail stocks. In this paper we assess Amazon's progress so far and reinforce our positive retail sector view given attractive valuations relative to sustainable free cash flow.

Online retail sales growth has accelerated

Online sales growth has accelerated

Following some weakness in mid-2017, online sales growth has accelerated to an estimated 16% in FY18 despite the backdrop of a more subdued consumer spending environment (Figure 8).

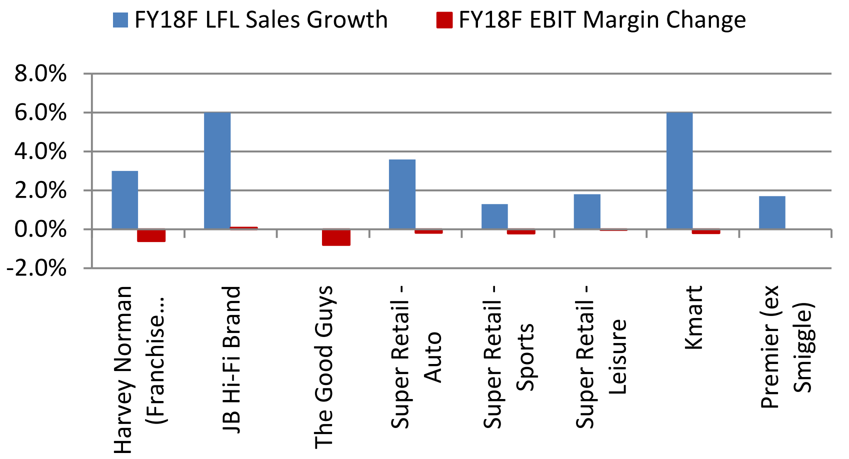
Figure 8: Growth in Online Retail Sales (Non-Food) vs Retail Sales (Non-Food)

Source: ABS, NAB, Merlon Estimates

We outlined why we expected this to be the case in our last report. We believed that Amazon's launch would be an important catalyst for online penetration. Both directly in terms of Amazon generating its own local sales, but also indirectly with the mass publicity for Amazon's launch driving increased awareness of online shopping and established retailers improving their online offerings to compete with Amazon (more on this later). There has also been significant new emphasis placed by retailers on cyber sales events such as Black Friday (a huge event in the US).

Despite this strong online sales growth, there has been no discernible impact yet on Australian retailer's sales and aside from some company specific issues, margins have been largely stable (Figure 9).

Figure 9: Discretionary Retail FY18F LFL sales growth and EBIT margin change



Source: Company Reports, Merlon Estimates

Discretionary retailers are growing sales with margins broadly stable except for Harvey Norman and The Good Guys

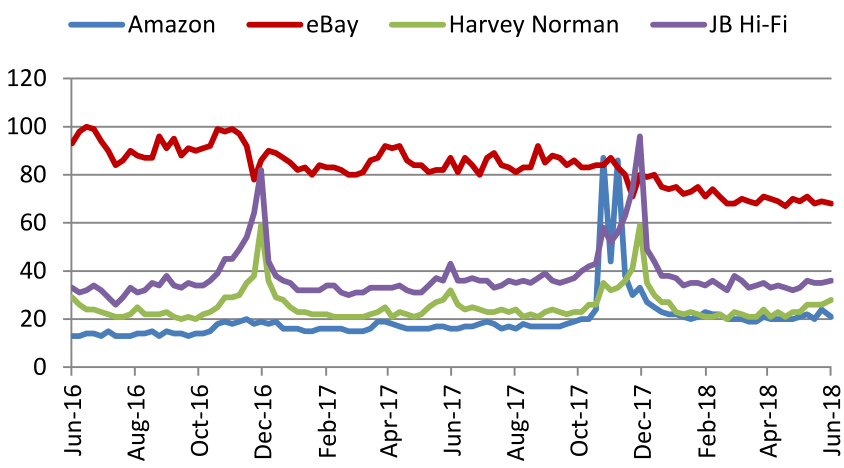
In the case of Harvey Norman and The Good Guys (TGG), there is currently a battle for market share in appliances which is causing material margin pressure. We expect this to be short-lived and not related to Amazon. Rather it is a consequence of Harvey Norman trying to capitalise on a destabilised TGG following the buy-out of its remaining Joint Venture Partners (JVPs) just prior to it being acquired by JB Hi-Fi. Other businesses such as the JB Hi-Fi brand and Super Retail's businesses have been reinvesting in price and/or costs to improve their in-store and online propositions but their margins are broadly unchanged. Regardless, most listed retailers are growing their online sales at a greater rate than the total online retail market as they put more focus on that channel and are growing off a low base. Given subsidised delivery and the cost of picking goods, it is likely these online sales will be lower margin than in-store sales but this is already factored into our and market long-term forecasts.

Launch failed to live up to the hype

After an initial false start on Black Friday (24 November 2017), Amazon finally launched on 5 December 2017. Despite much hype leading in, consumers were ultimately underwhelmed by the limited range and lack of deep discounts foreshadowed by the media.

Given Amazon's secretive nature it is unlikely it will disclose its Australian retail revenues for the foreseeable future. Regardless, it is fair to say that initial take-up has been below expectations. While by no means a perfect measure of web hits or sales, using the "Amazon" search term in the Google Trends tool (for Australia only) shows interest spiked around Black Friday and the eventual launch date but fell back to earth by January (Figure 10). While Amazon's search popularity has settled a little higher than prior to launch, it still lags eBay, JB Hi-Fi, and Harvey Norman. As we suggested in our last report, Amazon's growth seems to be coming mostly at eBay's expense given its significantly declining trend while JB Hi-Fi and Harvey Norman hold firm.

Figure 10: Google Trends index of retail search terms



Source: Google Trends, Merlon Estimates

Amazon Australia search term use is growing modestly

Initial retail offer was weak but is improving

As we expected, Amazon's initial product offering was relatively limited. The problem for Amazon is that the Australian site was always going to be compared to the US site, which is what Australian consumers are familiar with and will judge it against. But this is unfair since Amazon's US site has been operating since 1994 and operates in a much larger market.

Amazon's range and price are improving, albeit slower than many expected

While Amazon is operating across 23 retail categories, there are large gaps in the range with key brands (e.g. Apple, Samsung, Nike etc.) providing Amazon with either limited (often dated product) or no access to their own product ranges. Moreover, while the range has reportedly expanded to 60 million SKUs this is almost totally represented by third party sellers with Amazon's own range estimated to be only 1.5 million SKUs currently. In short, it will take many years for the Australian site to get anywhere approaching the range of the US site.

Reports of Amazon discounting prices by 40% were also predictably overplayed. We had assessed that Amazon's US pricing compared to JB Hi-Fi was already similar on a like for like basis except for a few select categories. However, we would note that Amazon's first party pricing has gotten sharper in recent months, particularly in media, gaming and small appliances. On the other hand, consumers have grown weary of third party sellers with pricing that is highly variable and at times exorbitant. Until this is corrected, Amazon's price perception will be hampered.

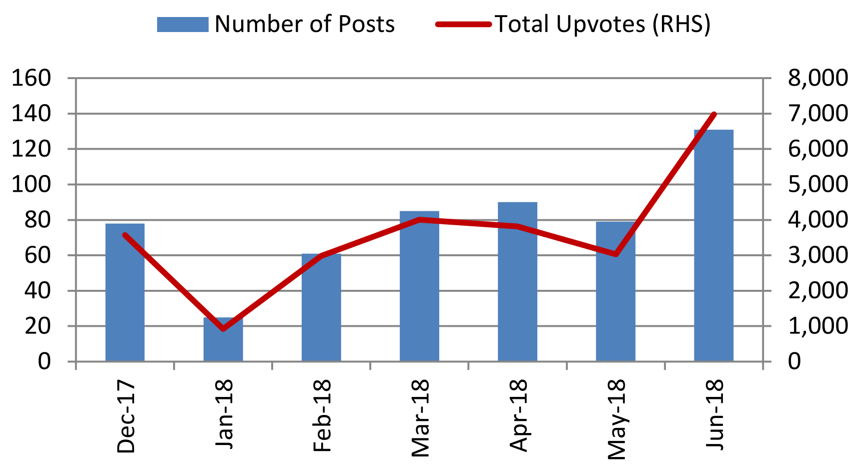
While pricing is still a mixed bag, Amazon is clearly becoming more aggressive on its marketing and promotions. We can observe this in a few ways.

First, up until 30 June 2018 Amazon had been offering new users a $20 discount code for purchases of $79 or more. While this in of itself an attractive offer, the offer has been blatantly abused by some customers (as shared on social media) who have been able to set up multiple accounts with the same shipping address and payment methods. The fact this has not been policed more strictly by Amazon probably suits itself anyway since it boosts subscriber numbers (likely a key KPI when reporting to head office).

Second, Amazon has been running a series of "Lightning Deals" and other special offers that have been heavily discounted for limited quantities and time (as is standard on their other sites). When combined with the $20 discount code and other programming quirks (i.e. items with an original price of greater than $79 that are heavily discounted have incorrectly been made eligible for the $20 discount) there has been some truly special deals for the most savvy consumers. To try to quantify the quality and cut-through of these offers we have been tracking OzBargain (ozbargain.com.au), an Australian community website where thrifty (or tight) consumers post deals by retailers. This site is an excellent indicator of which retailers are becoming more (or less) aggressive on price. The number of Amazon deals posted by users and the quality of these deals (as measured by user upvotes) has increased significantly over the last few months (Figure 11). As an indication, each post generates about 2,000 clicks on average through to Amazon's website so these deal posts can generate a meaningful amount of web traffic and sales.

Amazon's bargain deals are becoming more frequent and higher quality

Figure 11: Number of Amazon deal posts and upvotes on OzBargain



Source: OzBargain, Merlon Estimates

Third, Amazon has undertaken a significant marketing campaign across TV, Print, Digital etc. Its current "A-Z" themed advertising spots are running during prime time on FTA TV.

Finally, to mark the arrival of Amazon Prime, Amazon has announced that Amazon Prime Day will occur on 16 July 2018. This is a value-added sales event Amazon employs across its websites to encourage consumers to sign up to Prime. While there are likely to be some excellent deals, it is unlikely to match the significance of sales in other countries given the aforementioned more limited range available and very low numbers of current Australian Prime members.

Watered-down Amazon Prime is here

Amazon Prime will be a game changer, but not right now

The long anticipated launch of Amazon Prime is another area of improvement. However, this aspect of the local offering again feels like a cheap imitation of the real thing.

While it is indeed far cheaper than the US Prime, it is lacking in features (Figure 12). Most notably, while the two day free delivery is very competitive with current online retail offerings domestically, it does not match the one or same day free shipping provided by Amazon for US Prime members on certain items. We believe this reflects both the lack of Amazon's current scale and the challenges of lower population density that were discussed in our first paper. Also, while Amazon Prime Video access is included, it is a much narrower selection than the US equivalent since the rights to much of the content are already held by the likes of Netflix, Stan etc. Other features such as Prime Music (sold separately) and Prime Now are not included.

Figure 12: Key feature comparison of Amazon Prime Australia vs US

	Amazon Prime AU	Amazon Prime US
Cost	30 Day Free Trial. Thereafter $4.99/month till January 2019, increases to $6.99/month or $59/year	30 Day Free Trial. Thereafter US$12.99/month (A$17.60) or US$119/year (A$161)
Fastest Free Shipping time	Two days	Same day
Standard Delivery Option	Two day free delivery on eligible items to 90% of the population. Comparatively small selection	Two free day delivery available on more than 100 million items nationwide. Next day and same day delivery available in selected metro areas
Prime Now	No	One or two hour delivery
Prime Video	Yes	Yes
Prime Music	No (sold separately)	Yes
Prime Reading	Yes	Yes
Prime Photos	No	Yes

Source: Amazon, Merlon Estimates

It's important to acknowledge that Prime in Australia will improve over time as it gains scale. It will in particular be aided by the opening this year of the Sydney fulfilment centre (43,000 square metres), which will supplement Amazon's current Dandenong fulfilment centre (24,000 square metres).

Blocking access to Amazon's offshore sites

Amazon has stopped shipping to Australian customers from its offshore websites as of 1 July 2018. Instead, it will now offer a selection of Amazon US products to Australian customers through the Australian website.

The introduction of GST on low value offshore purchases will provide temporary relief to local retailers….

This brings home the real reason why Amazon launched last year. As outlined in our first Amazon report, we had been told that Amazon had decided to launch here due to the abolishment of GST low value threshold on overseas consumer purchases. It appears Amazon planned for this so that it could switch off its offshore websites to Australian customers. This move appears to be aimed at driving take-up of Australian site while also avoiding setting a precedent for other foreign governments to force Amazon and the like to collect GST. Australia is the first government to put the onus on vendors rather than customs to collect the GST since it will be costly. Interestingly, other retailers and marketplaces including eBay will not be blocking Australians access to offshore sellers.

Unsurprisingly, there has been a poor public reception to the change. The move is likely to cost it at least $500m of sales to its offshore sites, which will only partially be offset by increased domestic sales. In fact, with Australians spending an estimated $5b spent online at offshore websites, there is likely to be some swing back in spending to local online and bricks and mortar retailers given Amazon's actions and the fact that offshore goods under $1,000 have now become 10% more expensive.

Australian retailers are improving their online offers

Incumbent retailers and marketplaces are not waiting idly by to have their lunch cut by Amazon. While many retailers are lifting their games in the online space, three examples are worth highlighting, each with a key focus on shipping.

….while the battleground moves to delivery

JB Hi-Fi expanded its range of shipping options prior to Christmas with the aim of giving customers more choice. Customers can now opt for Express Delivery (one-to-two business days), Courier Delivery (same day) and Three Hour Rush delivery. While these options are not free, some customers will be willing to pay for added speed and certainty.

eBay has recently announced two significant initiatives to combat Amazon. Its eBay Plus program is similar to Prime, providing free shipping and returns on 15 million items from 10,000+ retailers. After a free 30 day trial, users will incur an introductory price of $29 for a 12 month subscription or $49 after the current offer expires.

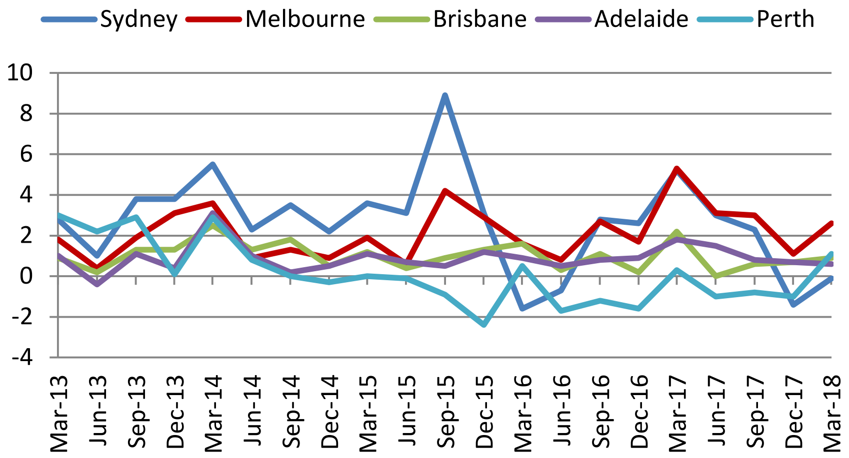
Lastly, Australia Post has launched Shipster, another subscription based program offering free shipping on orders of $25 or more at over 50 of Australia's largest retailers including Harvey Norman, Myer etc. It is priced similarly to Prime at $6.95/month but is free for the first two months with some partner retailers currently giving away 12 month memberships to loyalty card holders.

Housing market remains a greater cause for concern

Sydney house prices are softening with other markets mixed….

House prices are a key input into the consumer outlook given the link between household wealth and consumer spending. As previously outlined, Australian residential property is modestly overvalued but not to the extent suggested by many commentators (Are Concerns About Housing Prices Overblown?). More recently, the tightening of credit availability is putting downward pressure on house prices, particularly in Sydney (Figure 13). Notwithstanding this weakness, we still believe a house price crash is unlikely given the favourable tax treatment of housing, historically low interest rates and solid rental growth.

Figure 13: House price indexes (quarterly sequential growth)

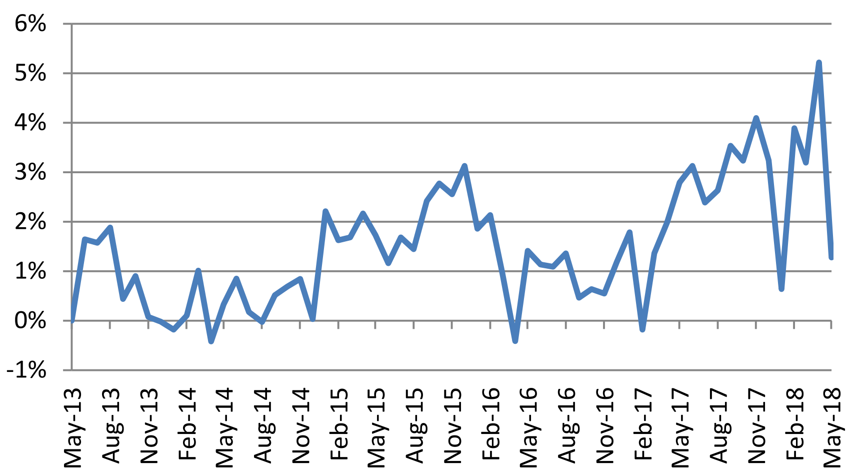


Source: ABS, Merlon Estimates

….but employment is very strong

Conversely, we believe the strength in the job market (as measured by monthly hours worked) is being overlooked by the market and should aid consumer spending (Figure 14).

Figure 14: Monthly hours worked (growth on pcp)



Source: ABS, Merlon Estimates

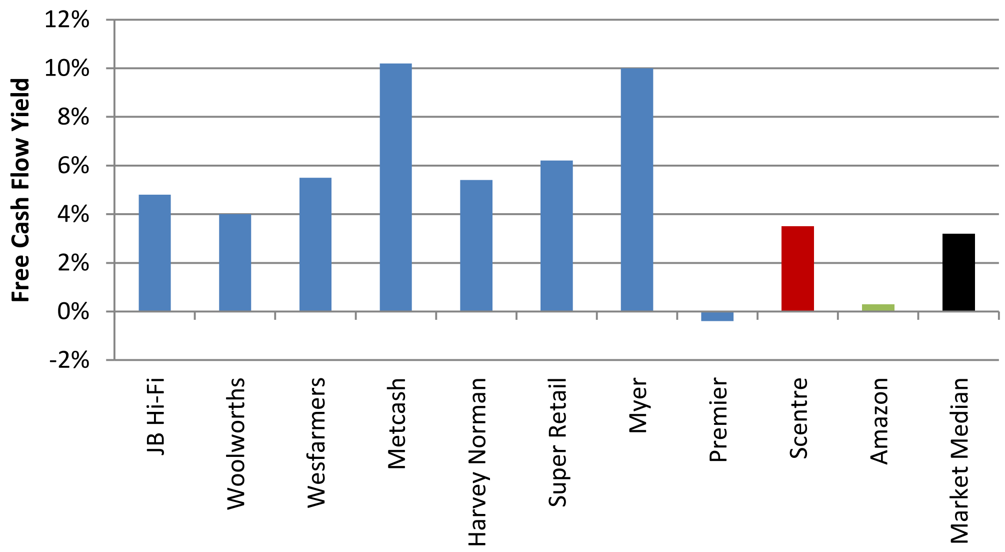
Retail sector still looks like good value

In summary, we continue to believe Amazon will be successful in Australia but that it will take a number of years. We do attempt to factor in Amazon and online competition more broadly by applying a meaningful sales and cash flow haircut to our long run estimates for each retailer, with a few exceptions where we believe online poses a limited threat (e.g. Bunnings). The more significant short to medium term threat is the slowing housing market. However, we remain relatively optimistic that we are not headed for a hard landing and also believe buoyant employment will support consumer spending.

While retail stocks generally enjoyed a sharp bounce over Christmas on rumours of strong trading and relief over Amazon's lacklustre launch, they have largely returned to prior depressed levels and continue to offer excellent value relative to the market (Figure 15).

Retail stocks offer some of the highest free cash flow yields in the market…

Figure 15: Last reported free cash flow yields



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

We retain positions in Harvey Norman, JB Hi-Fi, Super Retail, Wesfarmers, Woolworths and Metcash but have no exposure to retail Real Estate Investment Trusts.

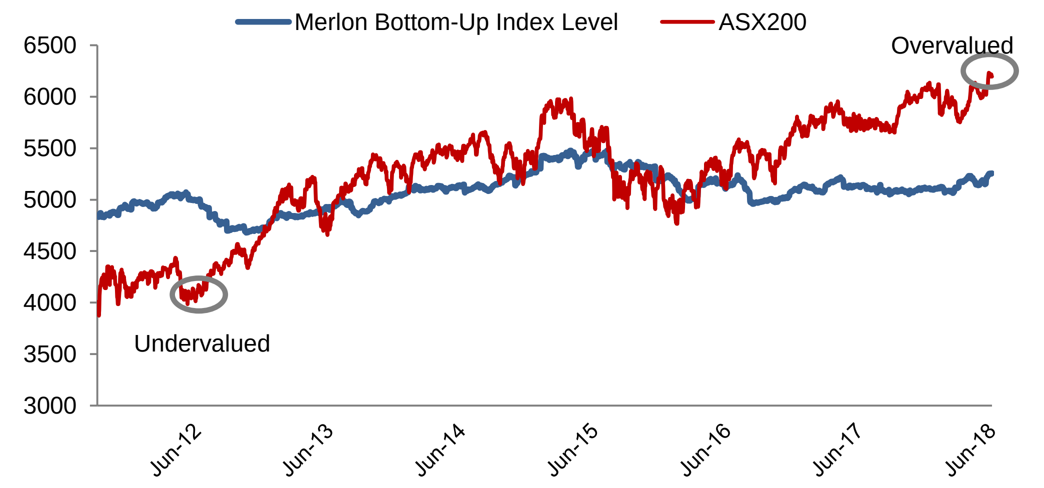
Neil Margolis

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 around 15% overvalued post the strong quarter (Figure 16). There continues to be wide dispersion across sectors, with resources, healthcare, property and infrastructure overvalued relative to other parts of the market. In our March quarterly report, we reflected on asset prices more broadly and concluded equities might well be the 'least worst' option if inflation and interest rates normalise as we expect (Some thoughts on asset prices).

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

Figure 16: Merlon bottom up market valuation vs ASX200 level

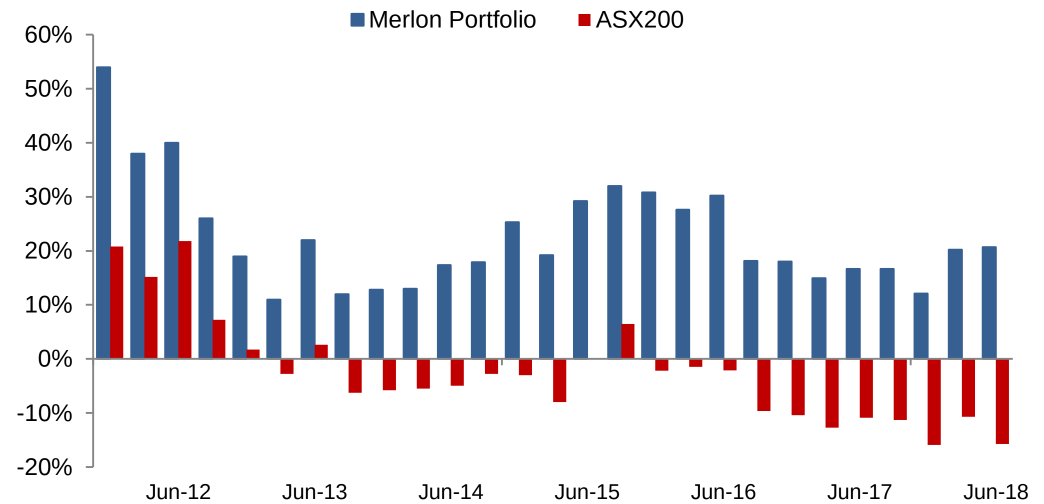


Source: Merlon

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

Merlon's value portfolio comprises our best research ideas, based on our long-term valuations and analyst conviction. As seen in Figure 17, the Merlon portfolio offers 20% absolute upside and is looking increasingly attractive relative to the index.

Figure 17: Expected return based on Merlon valuations



Source: Merlon

We invest on the basis that, over time, inflation and by implication 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** and **Clydesdale Bank** should benefit against this backdrop.

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

A weaker Australian dollar will provide a necessary offset to housing construction activity and house prices that are likely to continue moderating 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 and media companies, may not be as bad as what is currently priced into the stocks. Further, we have updated our thoughts on Amazon's Australian business and continue to believe the impact of Amazon is being overplayed and therefore see value in the discretionary consumer sector.

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. All this leaves the banks moderately undervalued in an expensive market.

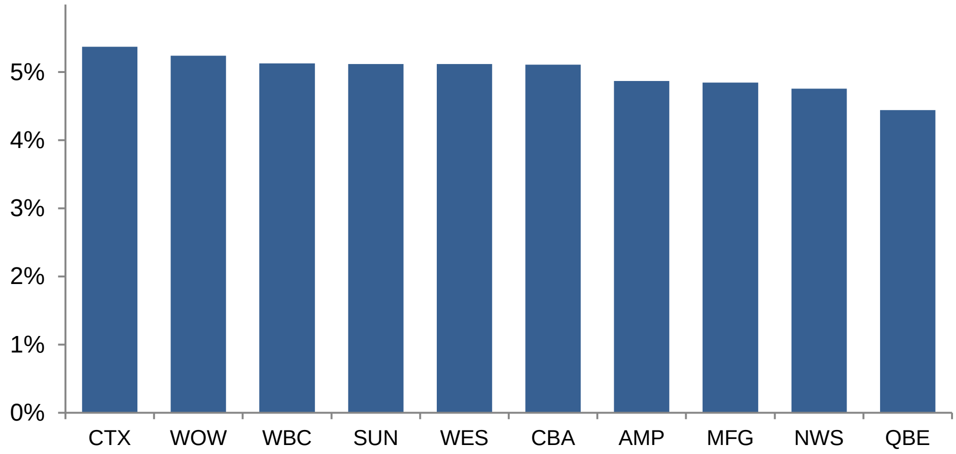
Portfolio Aligned to Value Philosophy and Fundamental Research

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

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.

Figure 18: Top ten holdings (gross weights)



Source: Merlon

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

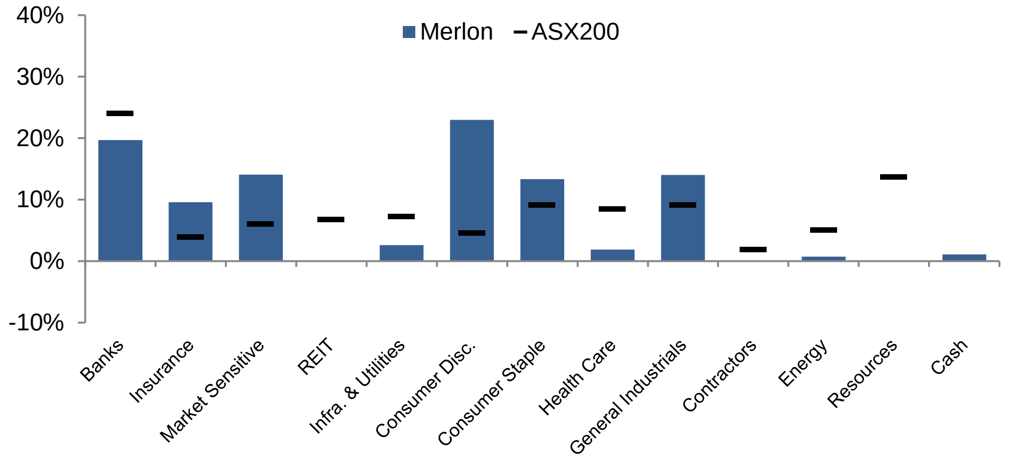
Our larger investments are typically in companies 'unloved' by the market but current prices can be justified by the higher quality and more predictable parts of their businesses.

The supermarket operators, **Woolworths** and **Wesfarmers**, are generating good cash-flows by competing rationally on convenience, range and value, not just price. We may have seen the worst in terms of industry price deflation, with Aldi market share maturing and Coles likely to be more rational as a separate listed entity.

The Royal Commission might constrain sales commissions to mortgage brokers, perversely favouring incumbent retail banks with strong branch footprints such as **Commonwealth Bank**, **Westpac** and **Suncorp**. We continue to see current retail bank returns as more sustainable than consensus given the near doubling of mortgage capital in recent years and re-pricing linked to regulatory handbrakes applied to investor lending.

Caltex is shifting to lower capital intensity within an improving industry structure; **News Corporation** is shifting from advertising to digital subscriptions and has net cash on balance sheet; **AMP** has suffered reputational damage with the Royal Commission but we believe the franchise will prove more resilient over time than what is factored into the share price, and cash generation remains strong as insurance is exited and the mix shifts to more cash generative funds management and advice; **QBE Insurance** has valuation support assuming minimal value outside of the domestic Australian and Lloyds businesses; and **Magellan Financial** generates strong and growing cash-flows with upside from performance fees, a debt-free balance sheet and USD-denominated FUM.

Figure 19: 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**, **Nine Entertainment Group**, **Southern Cross Media**, **Virtus Health** and **Sky TV New Zealand**.

Figure 20: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	32	200
Active Share	74%	0%
Merlon Valuation Upside	21%	-16%
EV / EBITDA	8.9x	12.2x
Price / Earnings Ratio	15.0x	17.3x
Price / Book Ratio	2.7x	3.9x
Trailing Free Cash Flow Yield	5.1%	5.0%

Source: Merlon

June Quarter Portfolio Activity

We introduced new investments in Platinum, Janus Henderson, Super Retail, Aurizon, Asaleo Care and ANZ Bank

During the quarter we introduced six new investments and exited three. The new investments are all below our maximum 5% position size at this time, as they are either not very undervalued, not yet at maximum analyst conviction or are smaller capitalisation stocks constrained by our liquidity limits.

We invested in fund managers, **Platinum Asset Management** and **Janus Henderson**, with both offering long-term cash-flow based value after factoring in market concerns around fund outflows and high asset prices generally. International fund managers are more defensive than the market perceives given the highly cyclical nature of the Australian Dollar and relatively low operating and financial leverage. Furthermore, Platinum has a defensive investment style and Janus Henderson a diversified product and asset class mix.

We invested in **Super Retail Group**, with the impact of online competition already factored into our sustainable cash-flow estimate for the sports and leisure retail businesses, and the auto parts business more immune in line with overseas experience.

We invested in **Aurizon Rail** with long-term fundamental value upside emerging after a poor regulatory decision on its monopoly rail business that we believe will improve over time.

We initiated a small investment in **Asaleo Care**, a manufacturer of personal hygiene and tissue products, with some strong brands and margins now more realistic after rebasing from unsustainable levels at the time of the IPO.

Within banks, we re-invested in **ANZ Bank**, with the major banks offering more fundamental upside after 20% underperformance relative to the market. A slowing mortgage market, rising fund costs and unsustainably low bad debts present risks, but lower, but still positive, credit growth and normalising bad debts are already factored into our estimate of sustainable free cash flow. All the banks, but ANZ in particular, are well capitalised and focused on reducing cost to offset weaker revenue trends.

We also added to existing positions in **AMP**, with the franchise expected to prove more resilient over time than what is currently factored into the share price; and **Amaysim**, with more confidence in long-term valuation upside after the CEO change, rebased mobile plans ahead of the fourth network operator and potential for energy retailing cross-sell.

Funded by exiting long-held positions in Origin Energy and Coca Cola Amatil

We funded these new investments by exiting our long-held position in **Origin Energy**, with the share price now exceeding our fundamental valuation as the market extrapolates high oil prices and wholesale electricity margins.

We also sold our **Coca Cola Amatil** position with the higher share price implying the market is now less concerned about declining soft drink consumption, the impact of the NSW Container Deposit Scheme and difficult trading conditions in Indonesia.

We exited a small position in **Telstra** early in the quarter when it became evident the market was overly optimistic about sustainable returns from the increasingly competitive mobile and NBN segments.

We reduced but still retain investments in **Clydesdale Bank**, given less optimism around the Virgin Money acquisition, and **Metcash**, with the share price rallying strongly prior to the announced loss of a major SA customer.

Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)
Portfolio Return (inc. franking)	2.6	4.6	7.4	7.4	12.4	12.5	13.1
ASX200 Return (inc. franking)	3.3	8.7	14.5	14.5	10.5	11.5	10.6
Excess Return*	**-0.7**	**-4.1**	**-7.1**	**-7.1**	**1.8**	**1.1**	**2.5**

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

June Quarter Market Review

The market posted its strongest quarter since early 2015, advancing 8.7% (including franking). US 10 year bonds climbed 14bp (+45bp since December) but the yield curve continued to flatten with 2 year bonds rising by more. Interestingly, the US 10 year bond yield extended its record spread over its Australian equivalent. Oil prices rose 14% but iron ore was little changed. The AUD edged lower, and according to RP Data, house prices declined 1% in the June quarter, with Sydney down mid-single digits over the past 12 months.

Unsurprisingly, **Energy** was the best performing sector, joined by **Materials**, **Consumer Staples** and **Healthcare**, which all posted double digit gains. **Financials**, including **Banks**, lagged again with political heat, concerns over tightening lending standards and rising short-term funding costs weighing on sentiment. **Real Estate Investment Trusts** (REITS) & **Infrastructure** kept pace with the market with corporate activity outweighing the impact of rising bond yields for now.

Portfolio Performance Review

The Strategy underperformed due to exposures to AMP, JB HiFi, Magellan and Navitas

The Concentrated Value Strategy increased 4.6% for the quarter, underperforming the ASX200 by 4.1%. The non-benchmark approach was a headwind, with the structural underweight to mega large-cap stocks detracting from relative performance.

Seven West Media was the best performing holding after signs the rate of decline in the TV advertising market is slowing, ratings improved and a good 'relative' deal was struck on snatching cricket rights from Channel Nine. **Wesfarmers** outperformed after exiting the disastrous UK hardware sector, announcing a demerger of Coles and reaffirming earnings have bottomed in the number two supermarket operator. **Southern Cross Media** outperformed after improved market share trends in metro radio. **Woolworths** outperformed on the back of another good quarterly sales result and signs Coles could be discounting less going forward. Rounding out the top five contributors was **Fletcher Building** after recapitalising the balance sheet and not issuing any more construction downgrades.

AMP was the biggest detractor after suffering reputational damage during Royal Commission proceedings, leading to significant management and board change. However, following our detailed review, we added to our position on the view the AMP is more diversified and the Advice franchise will prove to be more resilient than the market currently assumes. **JB HiFi** underperformed after announcing difficult trading conditions with The Good Guys, which is proving more difficult than expected to transition to corporate ownership. **Magellan Financial** underperformed on weaker than expected retail fund flows and **Navitas** on weaker than expected student enrolment data. **Metcash** rounded out the bottom contributors after announcing a key customer loss in South Australia.

At a sector level, not owning **Resources** and **REITs** detracted, as did exposure to **Consumer Discretionary** stocks, while **Consumer Staples** was the best performing sector for the Strategy.

The Strategy also underperformed over the financial year

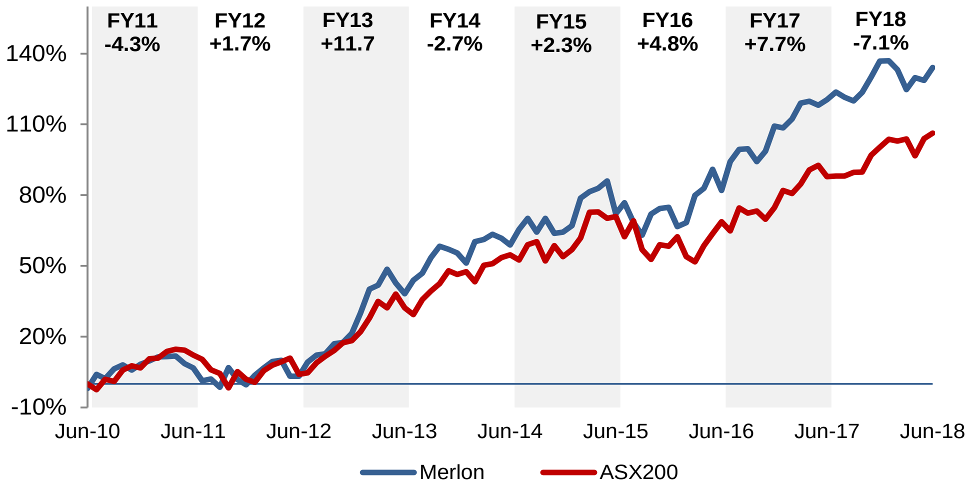
For the 2018 financial year, the Concentrated Value Strategy advanced 7.4%, significantly lagging the market's 14.5% rise (including franking). The benchmark unaware portfolio construction was a slight positive as the banks weighed on the market index. Key stock specific detractors included **AMP**, **Magellan Financial**, **QBE Insurance**, **Fletcher Building** and **TradeMe Group**. On the other side of the ledger, **Origin Energy**, **Wesfarmers**, **Metcash**, and not owing **Bank of Queensland** and **Ramsay healthcare** contributed most positively to relative returns.

Stock selection outcomes have been positive over longer-term periods

Longer-term, the Concentrated Value Strategy has outperformed by 2.5% per annum over the past 7 years, with underlying stock selection of 2.0% per annum enhanced by a non-benchmark construction tailwind of 0.5%. 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 **Telstra**, **National Australia Bank, Macquarie Bank**, **Tabcorp** and **Suncorp** the key contributors. Key detractors over this time frame include **QBE Insurance, AMP**, **Seven West Media**, **Worley Parsons**, as well as not owning **Aristocrat**. At a sector level, being underweight banks and owning minimal mining and energy stocks were the most notable contributors.

Figure 21: Cumulative total returns



Source: Merlon

Strategy FUM	Merlon FUM
$1,378.5m	$1,390.3m

About Merlon

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

Iron Ore is Well Above Sustainable Levels	Boral's High Priced Acquisition of Headwaters
Some Thoughts on Australian House Prices	Amazon Not Introducing Internet to Australia
Value Investing - An Australian Perspective: Part I	The Case for Fairfax Media Over REA Group
Value Investing - An Australian Perspective: Part II	Telstra Revisited
Value Investing - An Australian Perspective: Part III	Oil: The Cycle Continues
Some Thoughts on Asset Prices	Digital vs. Traditional Media - A Global Trend

Footnotes

[i] **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.

[ii] **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.