Merlon Income Strategy

Merlon Australian Share Income Fund

Quarterly Report

June 2019

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Good companies not always good investments

In this paper we consider the merits of systematically investing in "high quality" companies. We conclude that:

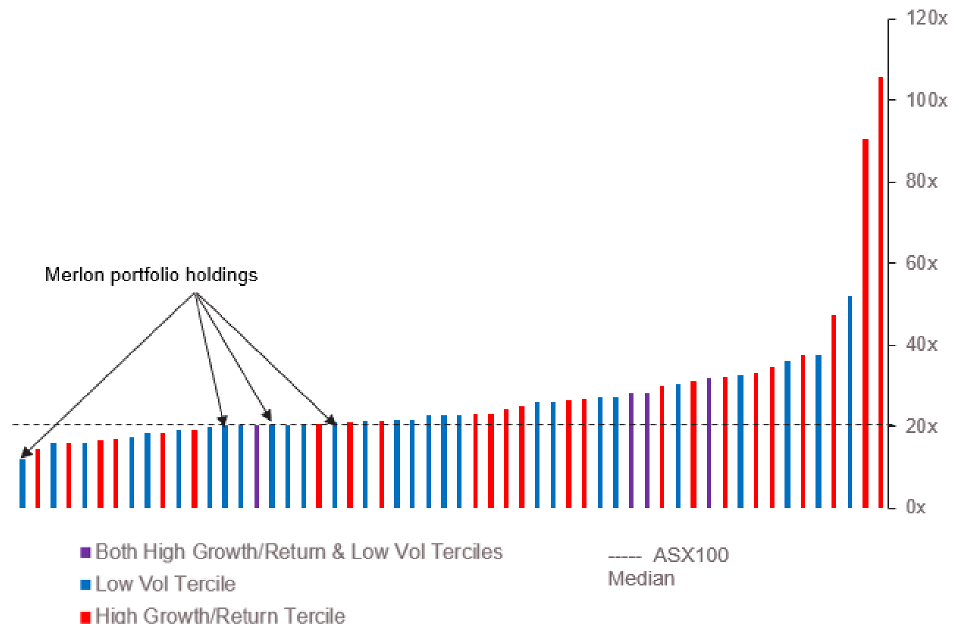
- ***Not all traditional "quality" factors have outperformed over a full market cycle***, with the performance of both "high growth/return" and "low volatility" stocks mixed. That said, certain "quality factors" have outperformed since the global financial crisis.

- ***Performance of certain quality factors have coincided with falling interest rates,*** a trend unlikely to persist indefinitely and at risk of retracing over longer time horizons.

- ***Traditional quality factors are currently expensive,*** with baskets of "quality" stocks trading at historically high earnings premiums to the broader market.

At Merlon, we do not "screen" based on "quality". In a subsequent paper, we will outline how Merlon's assessment of quality impacts our view of sustainable free cash flow and analyst conviction, which in turn drives investment decisions.

Figure 1: Enterprise Value-to-Free Cash Flow Multiple of "Quality" terciles



Source: Merlon Capital Partners/ Bloomberg, Free cash flow based on Merlon normalised estimates

The pursuit of quality

Investing in "quality" companies has been a commonly cited phrase in the investing community over the past few decades. There is no better person to encapsulate this transition from traditional "cigar-butt" value investing to a preference for quality, than Warren Buffett who stated "It's far better to buy a wonderful company at a fair price than

a fair company at a wonderful price". We would note however, that this shift is somewhat driven by limited value opportunities relative to Berkshire's meaningful scale.

A key question remains: what distinguishes a "quality" company from its more average peers? Anecdotes we have often heard include

- High quality, shareholder aligned management with proven track record
- Dominant market positions and strong barriers to entry
- High return on capital and attractive reinvestment opportunities
- Low earnings and stock volatility
- Stable and growing earnings
- Strong, defensive balance sheet

We agree that these are desirable attributes for a company to have. It would also not be difficult to build a portfolio of companies with these characteristics (as subjectively, most companies have a few).

However, as investors searching for mispriced businesses it is more important to consider the appropriate premium to pay for "high quality' attributes. If these "quality factors" are not systematically mispriced, owning "high quality" companies will not contribute to superior long-term returns.

Post-financial crisis "quality" investing

"Low volatility" stocks have had a good ten years but "high growth/ high return" less so……

The pervasive market view over the past 10 years has been the outperformance of companies with high quality attributes and strong growth. In the US, we have seen this trend encapsulated by the FAANGs (Facebook, Apple, Amazon, Netflix, Google). Closer to home, we have seen multiples expand above historical levels for companies that are

1. **High growth, high return on capital**[1]: Companies that are growing quickly and reinvesting profits into further growth at a high return-on-capital. Represented largely by globally exposed healthcare, online digital platforms, technology and semi-regulated infrastructure.
2. **Defensive, low volatility**[2]: Companies considered "safe" due to low earnings risk, stock volatility and historical market sensitivity. Largely composed of stocks in the healthcare, infrastructure, real estate investment trusts (REITs), consumer staples and bank sectors.

We agree that stocks in the defensive, low volatility basket have outperformed since the global financial crisis in 2008/09 (Figure 2).

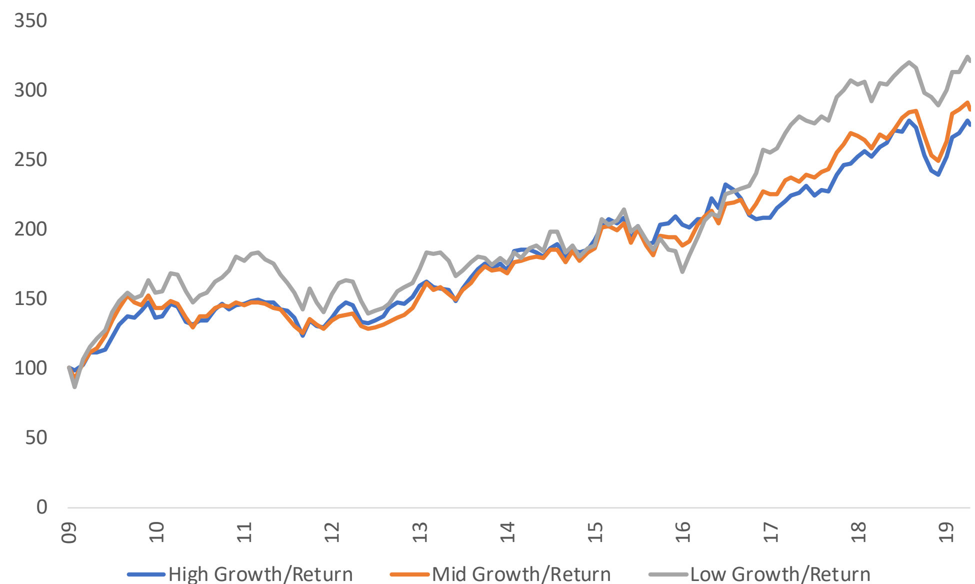
[1] As measured by FY1 EBITDA Margin, ROE over FY0 & FY3, Sales & EPS Growth; 3yr Historical + Forward
[2] As measured by Historical beta, FY1 consensus EPS dispersion , 2-month share price volatility, Market cap

Figure 2: Average ASX100 Constituent Returns by "Volatility" Terciles 2009-19

Source: Merlon Capital Partners/ Bloomberg/ Goldman Sachs Research

Using an equally weighted index, the average "high growth/return" stock however has **underperformed** over the same period, contrary to general views (Figure 3). We highlight that because the general market looks at the market cap-weighted index, the outperformance by a small number of large cap "high growth/return" stocks have skewed the misperception that the "growth/return" factor has outperformed in the ASX100 over the past ten years.

Figure 3: Average ASX100 Constituent Returns by "Growth/Return" Terciles 2009-19



Source: Merlon Capital Partners/ Bloomberg/ Goldman Sachs Research

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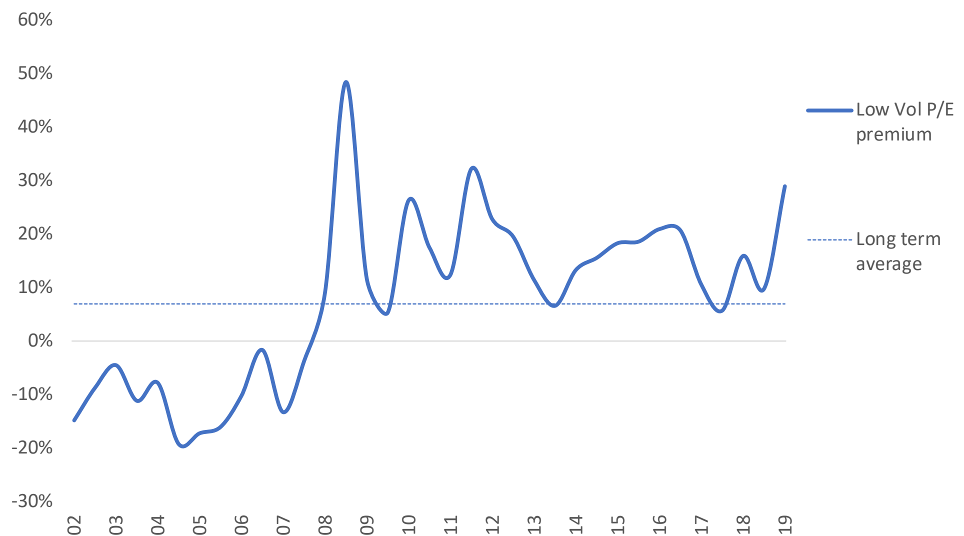
Premiums for perceived "quality" have expanded above historic norms…

Increasing overvaluation

*"Pursuing quality regardless of **price** is, in my opinion, one of the riskiest – rather than safest – of investment approaches" - Howard Marks*

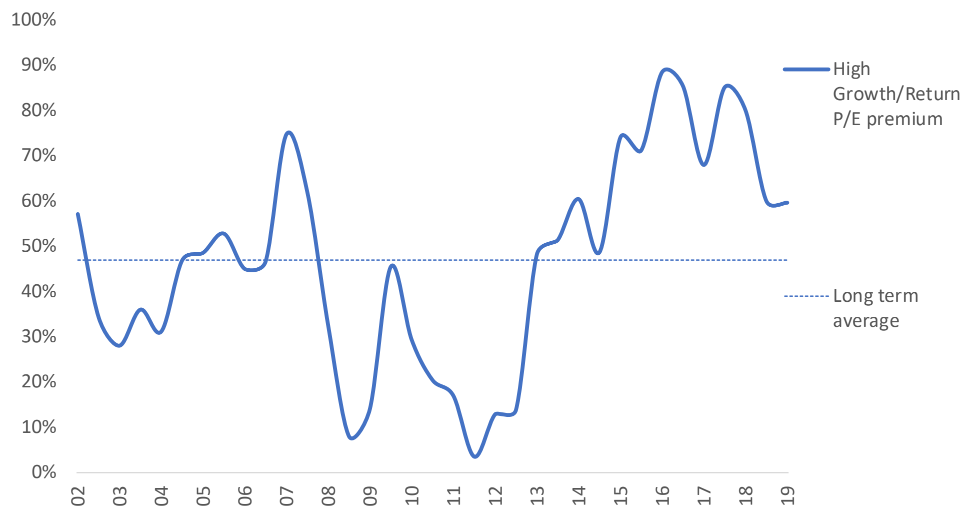
Historic performance is one thing but as forward-looking investors, we remain cautious on "high growth/return" and "low volatility" as proxies for quality investing, given the valuation premium ascribed to these stocks is high in a historic context. This highlights the share price gains that have not been supported by underlying earnings.

Figure 4: "Low Vol" Tercile P/E Premium Tercile vs Average ASX100 Constituent



Source: Merlon Capital Partners/ Bloomberg/ Goldman Sachs Research

Figure 5: "High Growth/Return" Tercile P/E Premium Tercile vs Average ASX100 Constituent



Source: Merlon Capital Partners/ Bloomberg/ Goldman Sachs Research

We argue that in the post-GFC environment characterised by low interest rates, inflation and macroeconomic growth, investors have clustered within these "quality" stocks.

Low interest rates a contributing factor

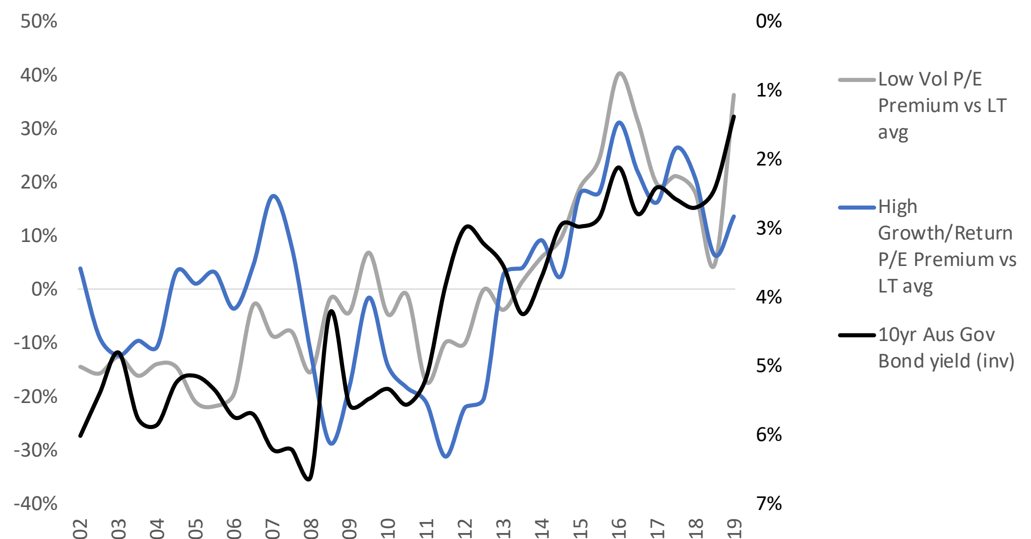
… driven in part by declining risk free rates with downside risk when interest rates normalise

We would argue that the ongoing reduction in interest rates has increased demand for perceived high-quality companies. Anecdotally, traditional fixed income investors have been increasing equity allocations while attempting to minimise additional risk. Likewise, the premium for companies growing at above average rates have benefitted from lowering of discount rates.

The lower interest rates go, the more sensitive valuations become to further reductions (or increases) in discount rates as opposed to changes in underlying cash flows.

We can observe this by examining the relationship between long-term government bonds and the valuation premium (Figure 6).

Figure 6: P/E Premium/(Discount) of "Quality" Terciles vs 10 yr Gov Bond yield (inv)



Source: Merlon Capital Partners/ Bloomberg/ RBA/ Goldman Sachs Research

We struggle to believe that real interest rates will remain negative indefinitely. Reversion of real interest rates upwards towards long term averages highlight the significant downside risk to these lofty valuation premiums for quality.

Investing in quality less compelling over the long term

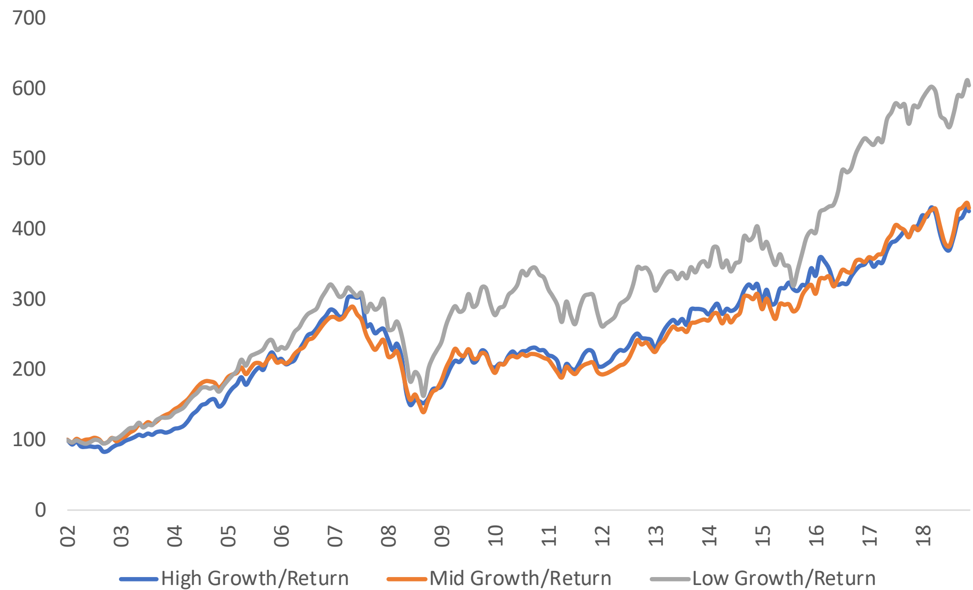
Limited evidence "quality" proxies work over a full market cycle

Ultimately, when we look at the long term evidence of whether certain definitions of "quality" warrant merit as a factor reflecting systemic bias in market pricing, the results are somewhat mixed. Over a full market cycle, the performance of both "high growth/return" and "low volatility" stocks have been mixed.

The average low growth/return stock has vastly outperformed the average high growth/return over a 15 year period (Figure 7). This is consistent with Merlon's prior research (Value vs Glamour) which highlights the market's bias in overpaying for high

growth "glamour" stocks whilst avoiding low or declining growth companies that are behaviourally uncomfortable to own or justify to clients.

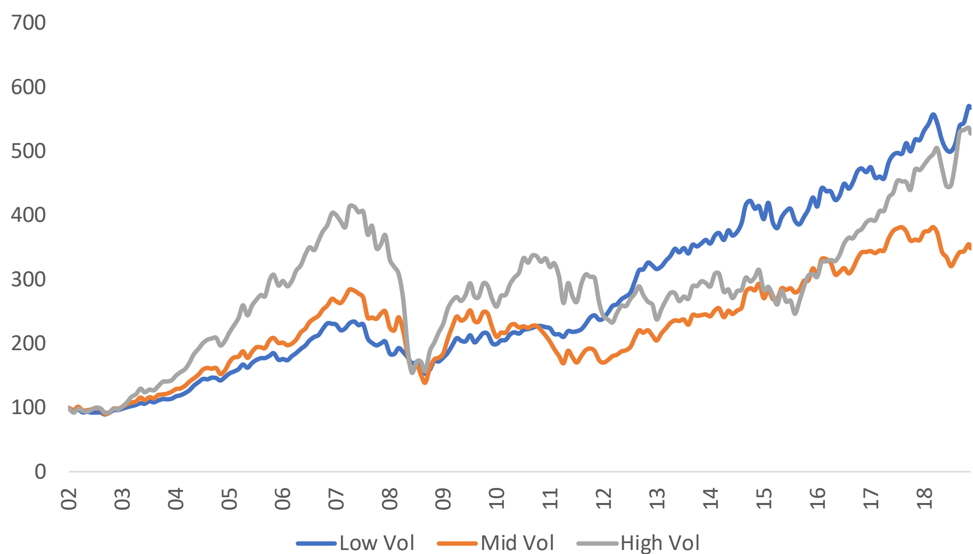
Figure 7: Average ASX100 Constituent Returns by "Growth/Return" Terciles, 2002-19



Source: Merlon Capital Partners/ Bloomberg/ RBA/ Goldman Sachs Research

While the average "low volatility" stock outperformed over both the long run (2002-2019) and post the GFC, this performance is largely matched by the "high volatility" stocks. Therefore, there is limited effectiveness in the volatility factor due its mixed performance.

Figure 8: Average ASX100 Constituent Returns by "Volatility" Terciles , 2002-19



Source: Merlon Capital Partners/ Bloomberg/ RBA/ Goldman Sachs Research

Conclusion

"Even the world's greatest business is not a good investment, if the ***price*** *is too high." Lou Simpson*

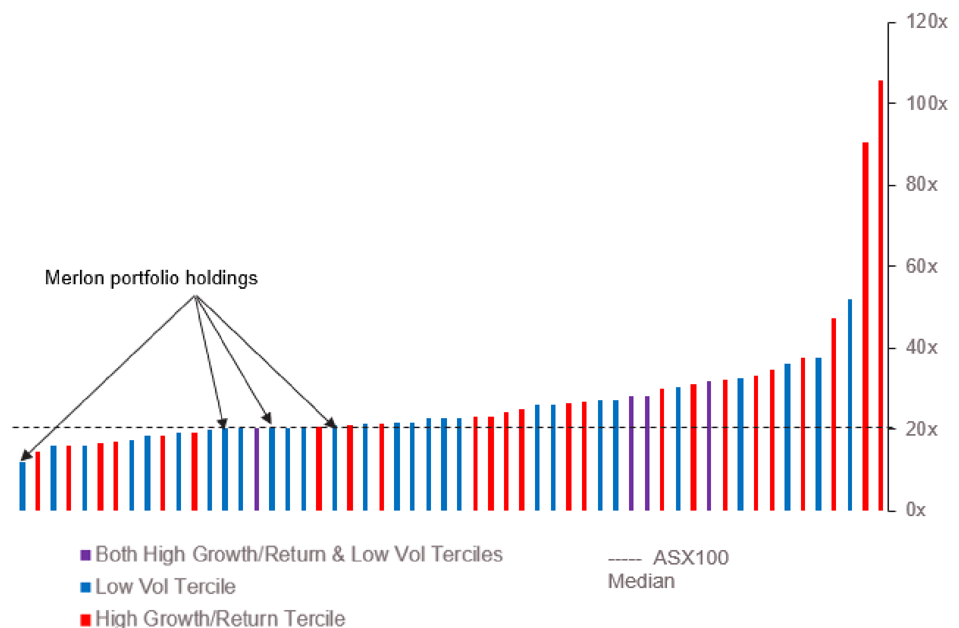
The market often has a short memory. It is easy to look back at the ten-year bull market and conclude that owning "high quality" companies is an easy route to investment outperformance. Yet there is little evidence that this strategy, in isolation, works over the long-term and through the fluctuations of the market cycle.

Additionally, as the market crowds into these stocks, their premium to market's multiple has risen to historically high levels. At the current point in the "quality premium" cycle, we are inclined to believe that these premiums should revert downwards to long-term averages over time.

At Merlon we do not "screen" based on "quality". In a subsequent paper, we will outline how Merlon's assessment of quality impacts our view of sustainable free cash flow and analyst conviction, which in turn drives investment decisions.

The chart below highlights the large premium enjoyed by most "high growth/return" and "low volatility" stocks even on a forward-looking normalised free cash flow basis. We do own a handful of "quality" companies defined this way, but only because they offer valuation upside and we have conviction that market concerns are overly discounted into the current share prices (Figure 9).

Figure 9: EV-to- Free Cash Flow Multiple of "Quality" terciles



Source: Merlon Capital Partners/ Bloomberg, Free cash flow based on Merlon normalised estimates

Considering the premium paid for "quality" attributes at present is well above historic norms, buying into "quality" runs a real risk of paying for good businesses but ultimately, making poor investments.

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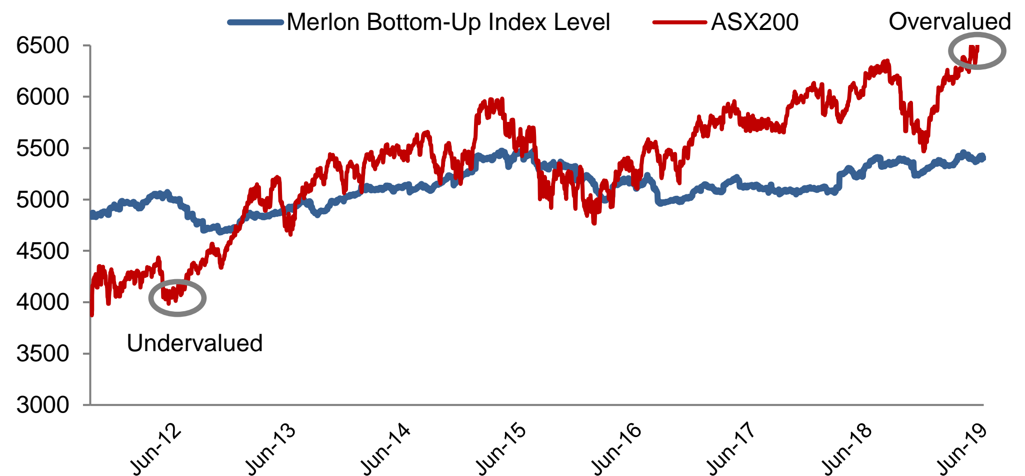
Market Outlook and Portfolio Positioning

Neil Margolis

As has been our historic practice, we continue to provide an aggregate assessment of the ASX200 valuation based on the individual company valuations for the 152 stocks we actively cover. On this basis the market appears approximately 19% overvalued after rising more than 8% during the quarter and 20% in the first half of this year.

Market approximately 19% overvalued using consistent bottom-up approach…

Figure 10: Merlon bottom up market valuation vs ASX200 level



Source: Merlon

Our individual company valuations have been established utilising our estimates of sustainable free-cash-flows and franking credits discounted at consistent mid-cycle interest rates and risk premiums. Our valuations are long-term and generally a lot more stable than fluctuating share prices, creating good opportunities for patient long-term investors.

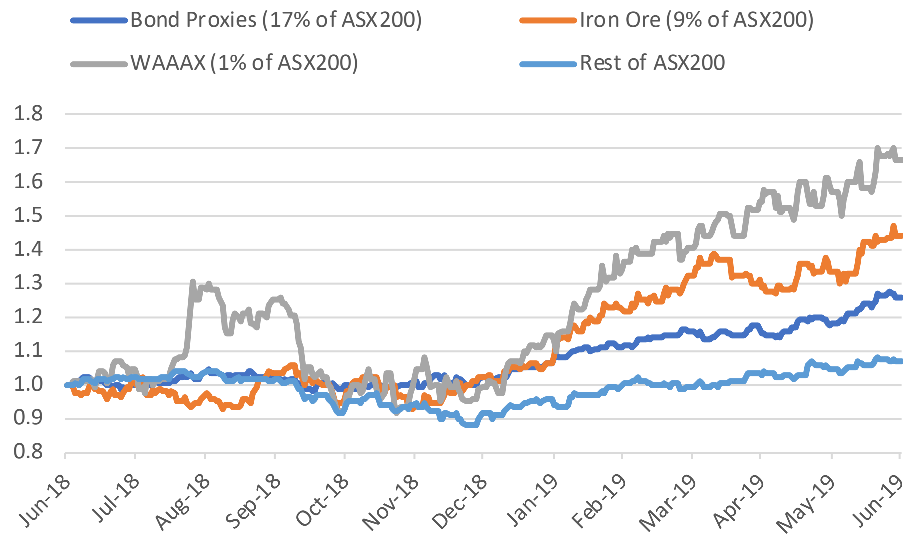
In addition to being less volatile, Merlon's consistent valuation approach across all companies also gives insight into where the market is overly concerned or overly complacent with regard to stock specific risks. This lens on valuation dispersion is more useful than trying to predict when and if the market will price in "mid-cycle" interest rates and long-run average risk premiums.

We have been concerned about valuations of "bond proxies", tech stocks and iron ore miners for some time…

As regular readers will be aware, we have been concerned about asset prices amongst "bond proxy" stocks, technology stocks and the iron ore sector for some time. It should come as no surprise therefore that the portfolio struggled to keep pace with the major market index during fiscal year 2019.

…yet these sectors continued to rapidly inflate through the June half.

Figure 11: Returns on Subcomponents of ASX200 Index (June 2018 = 1.00)

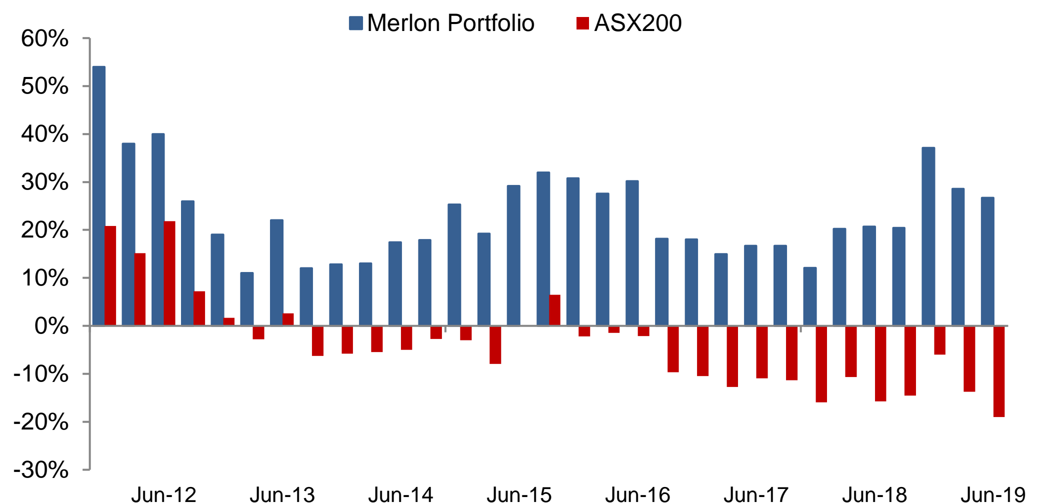


Source: Bloomberg, Merlon analysis

Merlon's value portfolio comprises our best research ideas, based on our long-term valuations and analyst conviction. Our long-term views in relation to the subcomponents of the ASX200 index identified above have not changed and the portfolio remains positioned against the recent trend of rapidly inflating asset prices in these areas. The implication (as seen below), is that the Merlon portfolio offers increasingly attractive expected returns compared to the index.

The Merlon portfolio offers increasingly attractive expected returns compared to the index.

Figure 12: Expected return based on Merlon valuations



Source: Merlon

The outlook for interest rates globally appears to be lower with the Federal Reserve now signalling that a cut is not out of the question. Locally, the Reserve Bank of Australia (RBA) cut current rates by 25bps in May, and a further 25bp reduction in early July citing sluggish growth and lower inflation expectations.

While timing is difficult to predict, we do not think it is prudent to invest in companies on the basis that real interest rates will remain negative for an extended period-of-time. Although equity markets have rallied, gains have been narrow and we are still able to construct a portfolio of undervalued businesses using sensible interest rate and risk margin assumptions.

The Australian dollar has held up remarkably well against a backdrop of slowing global growth and the relative fall in Australian interest rates. We put at least part of this strength down to the inflated iron-ore price that has benefitted from supply disruptions. Our positions in **QBE Insurance, Janus Henderson, Platinum** and **News Corporation** should benefit if the Australian dollar weakens further.

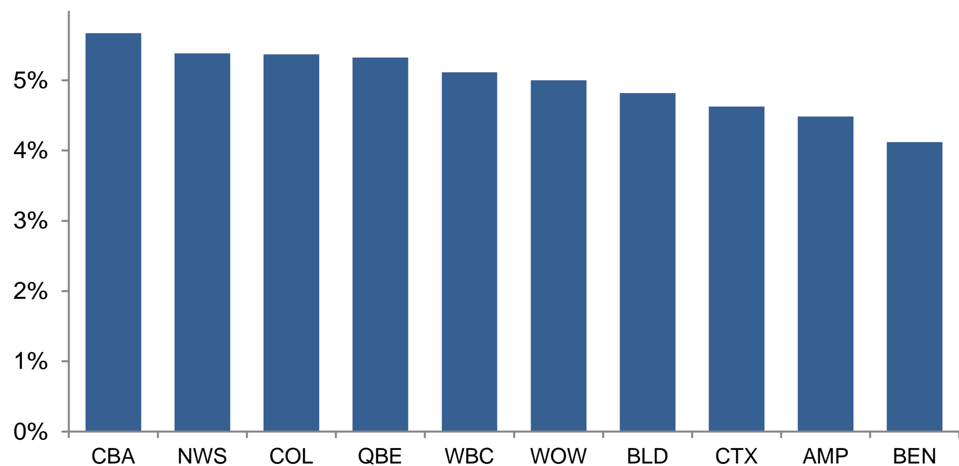
While recent interest rate cuts, tax cuts and macro-prudential easing should benefit the consumer and the housing market, this is against the tide of low wage growth, softening employment conditions and lower major bank risk appetite. That said, we believe on balance that much of this caution is reflected in low market expectations and select bank and consumer discretionary companies represent good investments at current levels.

Portfolio Aligned to Value Philosophy and Fundamental Research

The portfolio reflects our best bottom-up fundamental views rather than macro or sector specific themes…

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 13: Top ten holdings (gross weights)



Source: Merlon

…however there are clearly some macro themes in the portfolio

While we are not macro investors, as discussed above there are clearly some macro themes built into the portfolio. We need to be aware of these themes and ensure they do not expose us or our clients to unintended risks. In the first instance, any such risks are mitigated by our strategy of investing in companies that are under-valued relative to the sustainable free cash flows and the franking credits they generate for their owners. Attractive valuations strongly imply that market concerns are – at least to some extent – already reflected in expectations and provide a “margin of safety” in the event conditions adversely deteriorate.

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Our larger investments are typically in companies where investors have become overly pessimistic about long term prospects on account of weaker short-term performance. This tendency to extrapolate short-term conditions too far into the future and investors' focus on nonsensical measures of corporate financial performance instead of cash flow continue to present us with opportunities.

QBE Insurance Group is also a stock we like against the current macroeconomic backdrop. This company holds approximately US$23 billion of investments and cash, the majority of which is in floating rate fixed income investments and the majority of which is held outside Australia. Higher global interest rates will improve the running yield on this portfolio and increase the rate at which liabilities are discounted, the latter of which will strengthen the company's capital position. Management is now more focused, while interest rates are turning from a headwind into a tailwind, and the insurance pricing cycle appears to be improving, or at least no longer deteriorating.

Another example is a company like **Magellan Financial**, which is trading at a discount to the ASX200 on a simplistic price-earnings ratio, and notwithstanding the company's exceptional cash conversion (as evidenced by the recent dividend increase), debt free balance sheet, low operating leverage, strong distribution and the defensive positioning of its underlying funds (high cash holdings, short Australian dollar).

News Corporation is shifting away from more cyclical and macroeconomic exposed advertising income to subscription revenues. While Foxtel and the legacy print businesses face significant structural challenges, these assets are not being valued by the market to any material extent once we take into account the value of the company's online real estate classified businesses.

Caltex is an integrated refining and marketing company, with a refining business impacted by cyclically depressed refining margins, coupled with the effects of high petrol pricing on consumer demand. We have recently seen refining margins begin to improve, which has yet to be reflected in the market's pricing of Caltex. The company's marketing business continues to struggle with slightly weaker volumes, albeit in the context of a favourable and improving industry structure following the sale of Woolworth's petrol business to EG Group, a European petroleum marketer focused more on quality of offering rather than discounted fuels.

Much has been written on **AMP** after the Royal Commission caused the share price to decline by significantly more than our estimate of the fundamental value impact. Then, in an unrelated action, the directors decided to 'fire-sale' the wealth protection and mature business for 40% less than our - and the company's own disclosure - of cash-flow based value (Divestments & Shareholder Rights). We have added to the investment, as the expected return remains very attractive and more importantly the downside should be limited with the company now trading at a modest premium to tangible cash asset backing.

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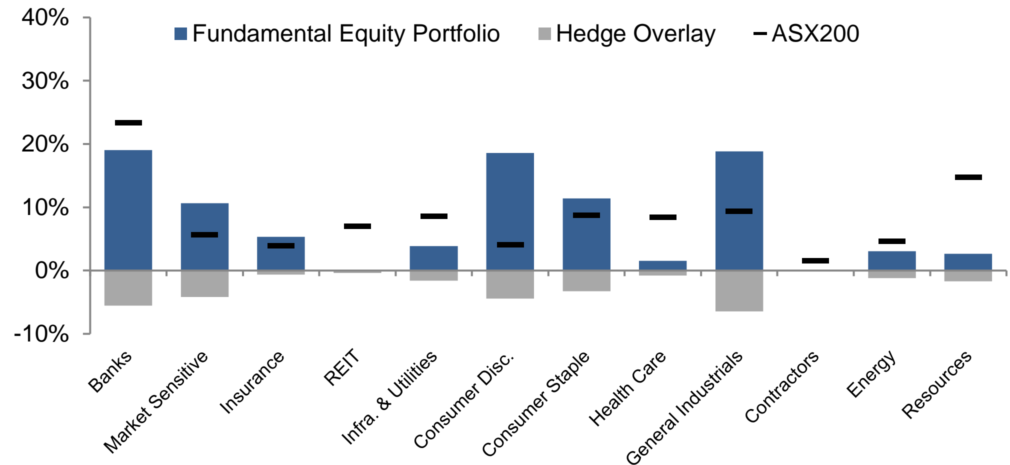
Figure 14: Portfolio exposures by sector (gross weights)



Source: Merlon

The hedge overlay offers material downside protection

At quarter end, the hedge overlay was broadly in-line with the targeted 30% reduction in market exposure while the portfolio remained fully invested in our best value ideas for the purposes of generating franked dividend income. The overlay is structural rather than tactical but does offer protection in the event markets have risen ahead of fundamentals in the short-term.

Figure 15: Portfolio Analytics[iv]

	Fund	ASX200
Number of Equity Positions	36	200
Active Share	75%	0%
Merlon Valuation Upside	27%	-19%
EV / EBITDA	7.9x	12.7x
Price / Earnings Ratio	14.9x	18.0x
Trailing Free Cash Flow Yield	5.6%	4.3%
Distribution Yield (inc. franking)	7.0%	5.4%
Net Equity Exposure	68%	100%

Source: Merlon

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June Quarter Portfolio Activity

During the quarter, we introduced three new investments …

During the quarter we re-invested in three companies we have owned previously, all of which have underperformed after we sold at levels above our previous fundamental valuations

We re-invested in **Super Retail Group**, with cyclical concerns already discounted in the 12x free cash flow multiple (versus 30x for the average company). The impact of online competition is also factored into our sustainable cash-flow estimate for the sports and leisure retail businesses, with the auto parts business more immune in line with overseas experience.

We re-invested in **Flight Centre**, which, like Super Retail, is trading at a very large cash flow multiple discount on account of cyclical (consumer spending) and structural (share loss to online) concerns. However, market share of total transaction value (TTV) has increased and the company has key offsets to weakness in Australian leisure bookings through its B2B and offshore segments.

We re-invested in **Clydesdale Bank** which has lost close to half its market value after acquiring Virgin Bank in the UK in 2018. The group's margins are now low compared to peers and a large cost-out programme to extract merger synergies offers a non-macro buffer to the earnings outlook.

We increased our existing position in **Boral** which underperformed further on cyclical concerns of a residential construction slowdown in Australia and the US.

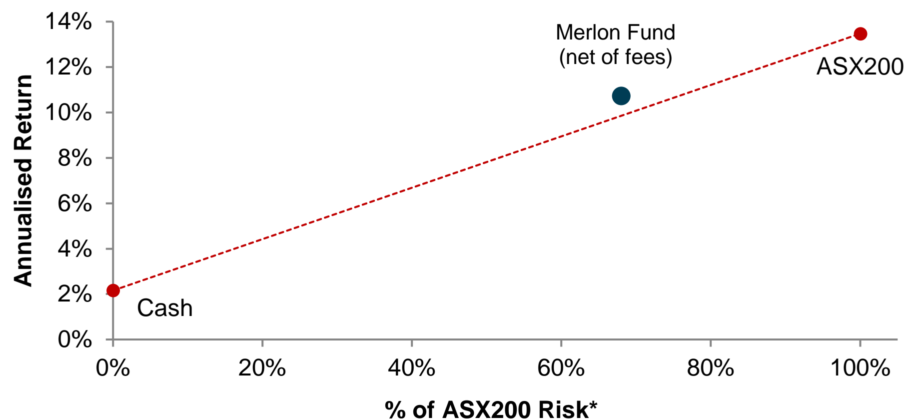
… funded by exiting five positions

These investments were funded by exiting long-held positions in **Magellan Financial**, which outperformed in excess of our long-term fundamental valuation, as investors shifted from concern to complacency with regard to market returns, relative performance and fund flows. We exited **Wesfarmers** which outperformed following the Coles demerger with investors becoming increasingly complacent about Bunnings growth and the sustainability of K-Mart's world-leading margins. We sold our investment in **Aurizon Rail** after a more favourable regulatory decision and customer negotiation alleviated investor concerns and caused the share price to outperform. We sold our position in **Suncorp Group** which no longer offered sufficient upside to compensate for risk of a strategic and earnings reset if the CEO were to depart, which is indeed what happened after we sold. Finally, we sold our small position in **Nine Entertainment Group** with the market too complacent about digital earnings outside of Domain classifieds and the structural challenges facing free-to-air television advertising.

Performance[i] (%) (after fees, inc. franking)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)	10 Years (p.a.)
Fund Total Return	0.6	4.3	6.5	6.5	9.0	7.8	10.7	9.2
70% ASX200 / 30% Bank Bills	2.6	5.9	9.9	9.9	10.6	8.0	10.2	9.1
ASX200	3.7	8.2	13.2	13.2	14.4	10.4	13.5	11.5
Average Daily Exposure	70%	71%	69%	69%	69%	69%	69%	70%
Gross Distribution Yield	0.4	2.0	7.9	7.9	7.6	7.6	7.9	9.0

Past performance is not a reliable indicator of future performance. Total returns above are grossed up for franking credits. Gross Distribution Yield represents the income return of the fund inclusive of franking credits. Portfolio inception date is 30/09/05.

Figure 16: Rolling Seven Year Risk vs. Return (%p.a.)[ii]



Source: Merlon

June Quarter Market & Portfolio Review

Large banks and iron ore miners led market gains during the quarter…

The market has closed in on all-time highs after rallying 8.2% (including franking) in the quarter. The **Banks** dominated index performance (+15%) partly driven by the surprise election result which reduced the tail risk of more substantial declines in house prices and the resultant economic fallout. Outside the banks, performance was still positive albeit slightly tilted towards iron ore miners, bond proxies and tech stocks.

The strong performance of the iron ore miners and the banks meant that large capitalisation indices significantly outperformed mid- and small- cap benchmarks. For example, the top 20 index was up 10% for the quarter compared to the ex-20 index which was up 6%.

The Fund's structural bias away from large caps was a headwind for relative performance…

Against this backdrop the Fund increased in value by 4.3% (net of fees and inclusive of franking), underperforming the ASX200 by 4.0%. This shortfall has two components:

The hedge overlay detracted 1.2%, which was less than expected in a strong quarter, with the momentum based approach of tilting the hedge within the portfolio partly offsetting the structurally lower equity exposure.

The underlying share portfolio underperformed by 2.6% primarily driven by the non-benchmark construction that means that it will be structurally underweight larger index constituents, which represented a headwind for the quarter.

Top contributors to the mandate were **Magellan Financial Group**, **Commonwealth Bank** and **Aurizon** while **QBE, IOOF** and **Viva Energy** were the largest detractors.

2019 Financial Year Market & Portfolio Review

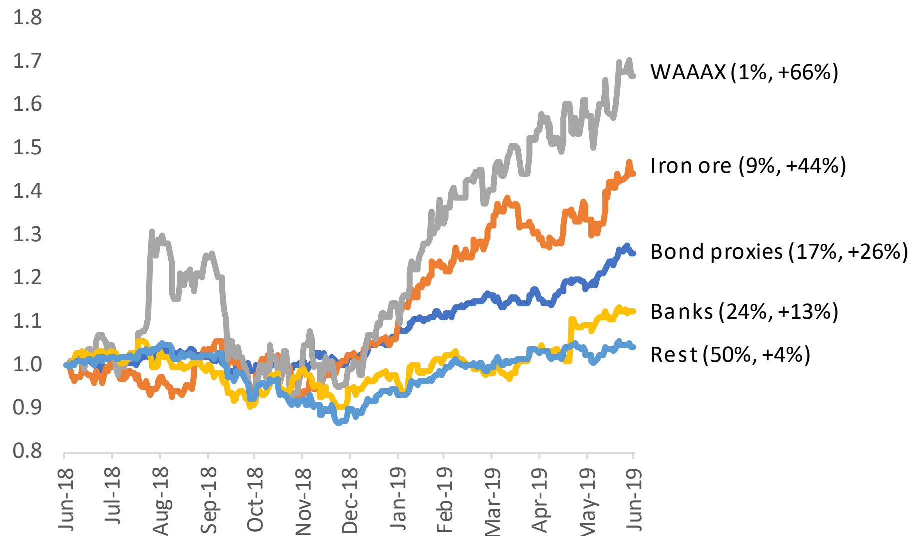
The June quarter brought to an end Merlon's ninth year of operations and the strategy's 7th consecutive year of positive returns with the Fund up 6.5% (net of fees and including franking). The Fund lagged the market with the hedge overlay detracting 0.9%, as we would expect given the strong market returns. However, by actively managing where the hedge positions are allocated within the portfolio the Fund achieved 89% of the share portfolio's return whilst maintaining 69% net equity exposure over the year.

The Fund's performance over the year was pleasing…

…and was achieved without speculating about short term dislocations

The underlying share portfolio underperformed a market that was led by tech stocks, iron ore miners, bond proxies and more recently banks.

Figure 17: Subcomponents of ASX200 Index (% of Index, Cap Weighted, Jun-18=1.00)



Source: Bloomberg, Merlon analysis

Given our calculated and deliberate positioning away from the tech sector, iron ore miners and many of the bond proxies through the year, the fund's performance was pleasing and was achieved without speculating about new valuation paradigms, the permanency of recent iron ore supply disruptions or the sustainability of negative real interest rates.

Put simply, we continue to regard such speculation to be a highly imprudent use of our clients and our own savings.

Magellan Financial more than doubled over the year and was the best performing holding with funds under management growth and performance fees surpassing market expectations. **Trade Me** delivered a 55% return over the year, the second best performing

holding and benefitted from a takeover offer that we believe reflected a fair price for the business, albeit without a material control premium. **Aurizon** (34% return over the year), **QBE** (28% return over the year) and **Commonwealth Bank** (23% return over the year) also made meaningful contributions to the full year result.

As always, there were some noteworthy poor performers for the year led by **AMP** which fell 37% net of dividends over the course of the year primarily as a result of the self inflicted and value destructive sale of the company's life insurance operations. **Fletcher Building** was also a poor performer which fell 26% due to further losses on constuction contracts and the softening housing market. **Caltex** fell 19% during the year on weak refining margins and poor retail results while **Seven West Media** (a smaller position) fell 45% and **Sky TV** (another smaller position) fell 47%.

The last seven years has seen the Fund deliver almost 80% of the market's 13.5% per annum return with a materially lower risk profile. Again, this reflects favourably on underlying stock selection which is 1.6% per annum above the ASX200. The structurally lower risk profile is demonstrated by the daily average market exposure of 69% and the seven year monthly beta of 0.70.

The additional performance information over the page is presented on a financial year basis and should be read in conjunction with the summary performance table on page 19.

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Additional Performance Detail: Sources of Return

FY Performance[i] (%) (inc. franking)	2019	2018	2017	2016	2015	2014	2013	7 Years (p.a.)
Underlying Share Portfolio	8.4	7.4	23.5	7.0	9.5	16.3	36.0	15.0
Hedge Overlay	-0.9	-2.3	-5.6	-0.9	-1.7	-3.5	-9.3	-3.2
Fund Return (before fees)	7.5	5.1	17.9	6.1	7.8	12.8	26.7	11.8
Fund Return (after fees)	6.5	4.1	16.8	5.1	6.8	11.8	25.6	10.7

FY Performance[i] (%) (before fees, inc. franking)	2019	2018	2017	2016	2015	2014	2013	7 Years (p.a.)
Underlying Share Portfolio	8.4	7.4	23.5	7.0	9.5	16.3	36.0	15.0
ASX200	13.2	14.5	15.5	2.2	7.2	18.9	24.3	13.5
Excess Return	-4.8	-7.1	8.0	4.8	2.3	-2.7	11.7	1.6

FY Performance[i] (%) (after fees)	2019	2018	2017	2016	2015	2014	2013	7 Years (p.a.)
Income	5.8	5.5	6.2	5.9	5.6	5.8	7.8	6.1
Franking	2.2	1.5	1.6	2.1	1.9	1.7	2.3	1.9
Growth	-1.4	-2.8	9.0	-2.9	-0.7	4.3	15.5	2.8
Fund Return (after fees)	6.5	5.1	16.8	5.1	6.8	11.8	25.6	10.7

FY Performance[i] (%) (after fees, inc. franking)	2019	2018	2017	2016	2015	2014	2013	7 Years (p.a.)
Fund Return (after fees)	6.5	5.1	16.8	5.1	6.8	11.8	25.6	10.7
70% ASX200/30% Bank Bills	9.9	10.6	11.3	2.2	6.0	14.0	17.8	10.2
Excess Return	-3.4	-5.4	5.5	2.9	0.8	-2.2	7.7	0.5

Monthly Distribution Detail: Cents per Unit

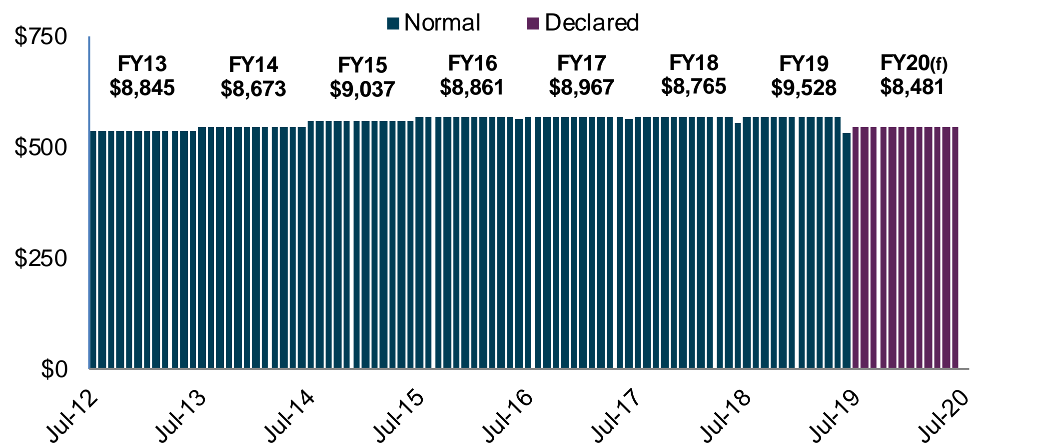
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Total	Franking
FY2013	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.29	**6.79**	2.26
FY2014	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.52	**6.13**	1.98
FY2015	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	**6.24**	2.20
FY2016	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.52	**6.35**	1.92
FY2017	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	**6.36**	2.02
FY2018	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.52	**6.35**	1.84
FY2019	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.50	**6.33**	2.57
FY2020	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	*0.51*	***6.12***	*1.80*

Highlighted data are estimates at the date of this report.

Monthly income will be 0.51 cents per unit at least through to May 2020…

and the franking level is projected to be in the 70-80% range

Figure 18: Monthly Income from $100,000 invested in July 2012[iii]



Source: Merlon, excludes bonus income in FY13

MERLON CAPITAL PARTNERS

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MERLON
CAPITAL PARTNERS

Fund Details

Fund size	$ 570m	Merlon FUM	$ 1,460m
APIR Code	HBC0011AU	Distribution Frequency	Monthly
ASX Code	MLO02	Minimum Investment	$ 10,000
Inception Date	30 September 2005	Buy / Sell Spread	+/- 0.20%

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 take 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"

About the Fund

The Merlon Australian Share Income Fund's investment approach is to construct a portfolio of undervalued companies, based on sustainable free cash flow, whilst using options to overlay downside protection on holdings with poor short-term momentum characteristics. An outcome of the investment style is a higher level of tax-effective income, paid monthly, along with the potential for capital growth over the medium-term.

Differentiating Features of the Fund

- **Deep fundamental research** with a track record of outperformance. This is where we spend the vast majority of our time and ultimately how we expect to deliver superior risk-adjusted returns for investors.

- **Portfolio diversification** with no reference to index weights. The benchmark unaware approach to portfolio construction is a key structural feature, especially given the concentrated nature of the ASX200 index.

- **Downside protection** through fundamental research and the hedge overlay. In addition to placing a heavy emphasis on capital preservation through our fundamental research, we use derivatives to reduce the Fund's market exposure and risk by 30% whilst still retaining all of the dividends and franking credits from the portfolio.

- **Sustainable income**, paid monthly and majority franked. As the Fund's name suggests, sustainable above-market income is a key objective but it is an outcome of our investment approach.

Footnotes

[i] **Performance (%)**

Average Daily Market Exposure is calculated as the daily net market exposure divided by the average net asset value of the Fund.

Composite benchmark is calculated as 70% S&P/ASX200 Accumulation Index and 30% Bloomberg AusBond Bank Bills Index. The Fund reduces exposure to share market volatility to a typical range of 60-80% through the use of derivatives with the remaining 20-40% option protection seeking to deliver a cash-like risk/return profile.

Fund Franking : Month 0.0%, Qtr 0.6%, FYTD 2.1%, Year 2.1%, 3 Years 1.7% p.a., 5 Years 1.9% p.a., 7 Years 1.9% p.a., 10 Years 2.1% p.a.

ASX200 Franking: Month 0.0%, Qtr 0.3%, FYTD 1.7%, Year 1.7%, 3 Years 1.5% p.a., 5 Years 1.5% p.a., 7 Years 1.5% p.a.,10 Years 1.5% p.a.

[ii] **Rolling Seven Year Performance History**

Past performance is not a reliable indicator of future performance. Returns for the Fund and ASX200 grossed up for accrued franking credits and the Fund return is stated after fees as at the date of this report, assumes distributions are reinvested.

% of ASX200 Risk represents the Fund's statistical beta relative to the ASX200

[iii] **Monthly Income from $100,000 invested in July 2012**

Past performance is not a reliable indicator of future performance. Income returns exclude 'bonus income' from above-normal hedging gains of $849 in FY13 and assume no bonus income in FY18 estimate. Income includes franking credits of; $2,420 (FY13), $2,120 (FY14), $2,356 (FY15), $2,057 (FY16), $2,159 (FY17), $1,966 (FY18) and $2,034 (FY19 estimate).

[iv] **Portfolio Analytics**

Source: Merlon, Active share is the sum of the absolute value of the differences of the weight of each holding in the portfolio versus the benchmark, and dividing by two. It is essentially stating how different the portfolio is from the benchmark. Net equity exposure represents the Fund's net equity exposure after cash holding's and hedging Beta measures the volatility of the fund compared with the market as a whole. EV / EBITDA equals a company's enterprise value (value of both equity and debt) divided by earnings before interest, tax, depreciation, and amortization, a commonly used valuation ratio that allows for comparisons without the effects of debt and taxation.

Disclaimer

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