Merlon Concentrated Value Strategy

Quarterly Report

June 2019

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Analyst:
Joey Mui

Good companies not always good investments

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

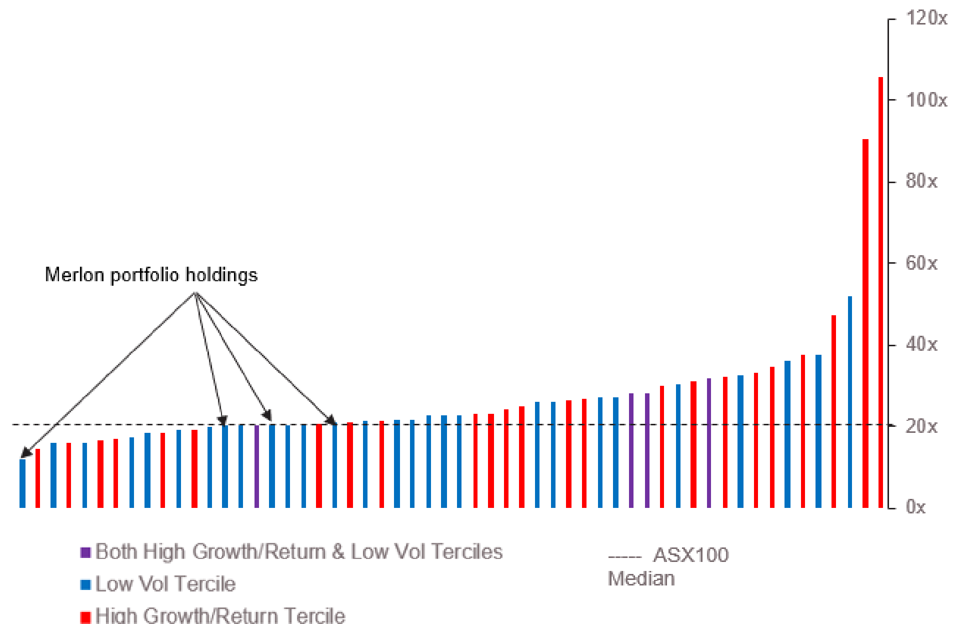
- ***Not all traditional "quality" factors have outperformed over a full market cycle***, with the performance of both "high growth/return" and "low "volatility" stocks mixed. That said, certain "quality factors" have outperformed since the global financial crisis.

- ***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, 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).

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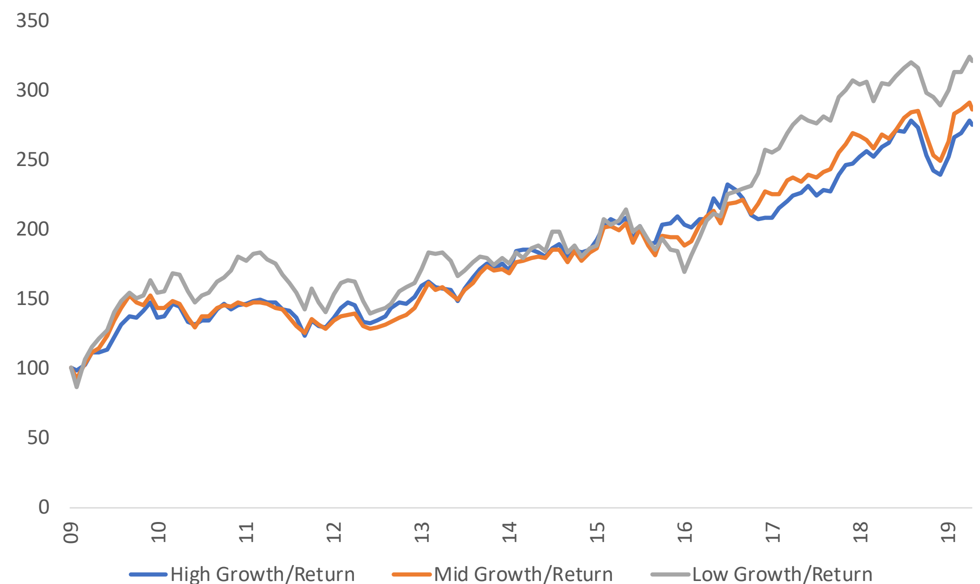
[1] As measured by FY1 EBITDA Margin, ROE over FY0 & FY3, Sales & EPS Growth; 3yr Historical + Forward
[2] As measured by Historical beta, FY1 consensus EPS dispersion , 2-month share price volatility, Market cap

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

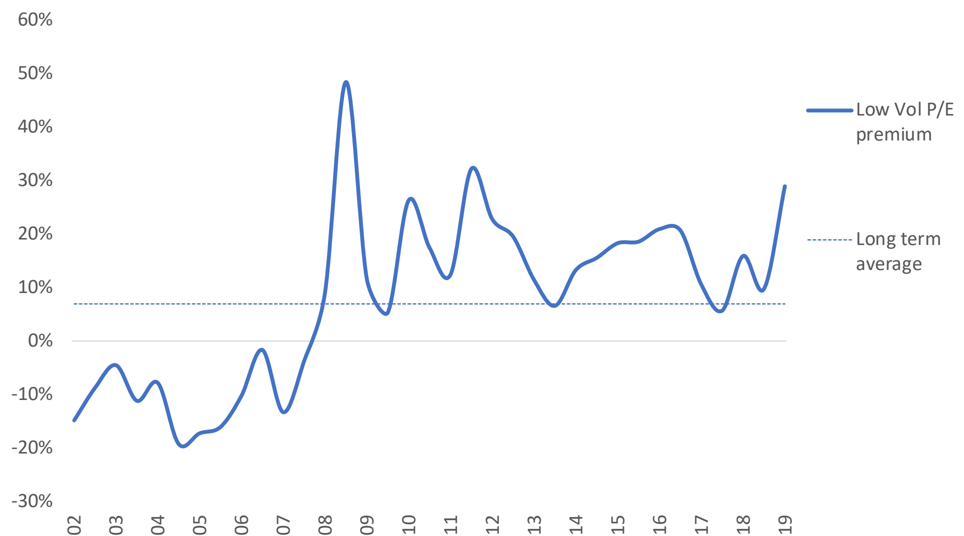
Premiums for perceived "quality" have expanded above historic norms…

Increasing overvaluation

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

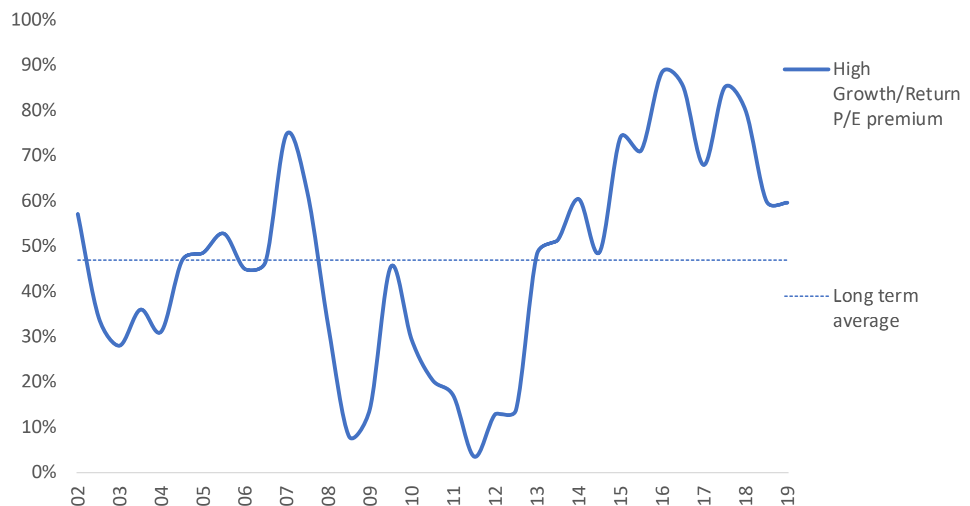
Historic performance is one thing but as forward-looking investors, we remain cautious on "high growth/return" and "low volatility" as proxies for quality investing, given the valuation premium ascribed to these stocks is high in a historic context. This highlights the share price gains have not been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

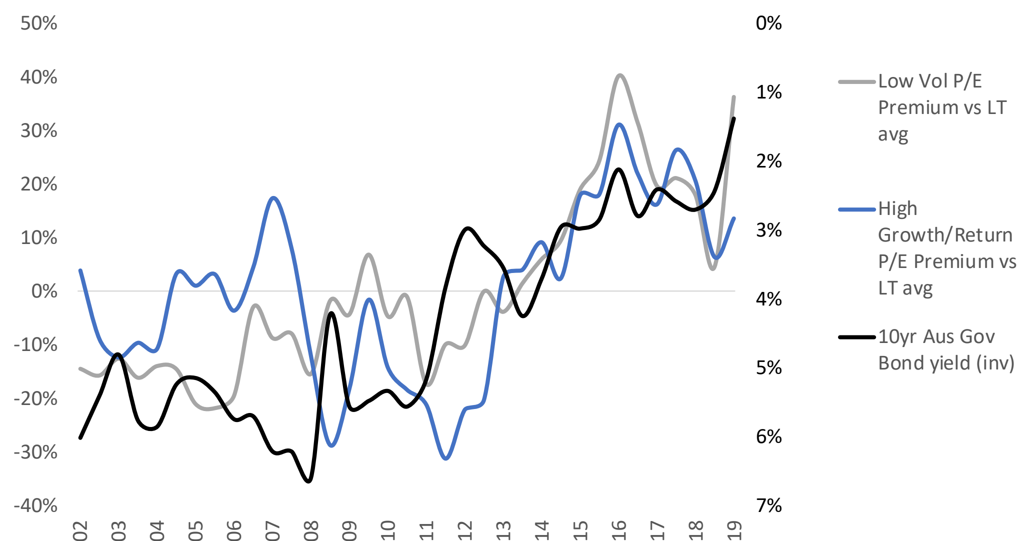
… driven in part by declining risk free rates with downside risk when interest rates normalise

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 7).

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

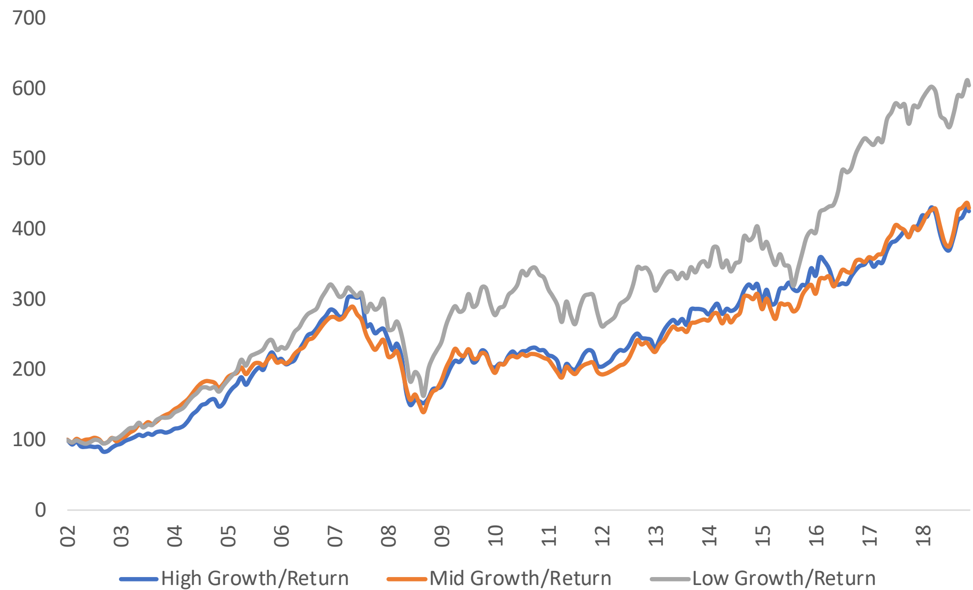
Limited evidence "quality" proxies work over a full market cycle

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 8). 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.

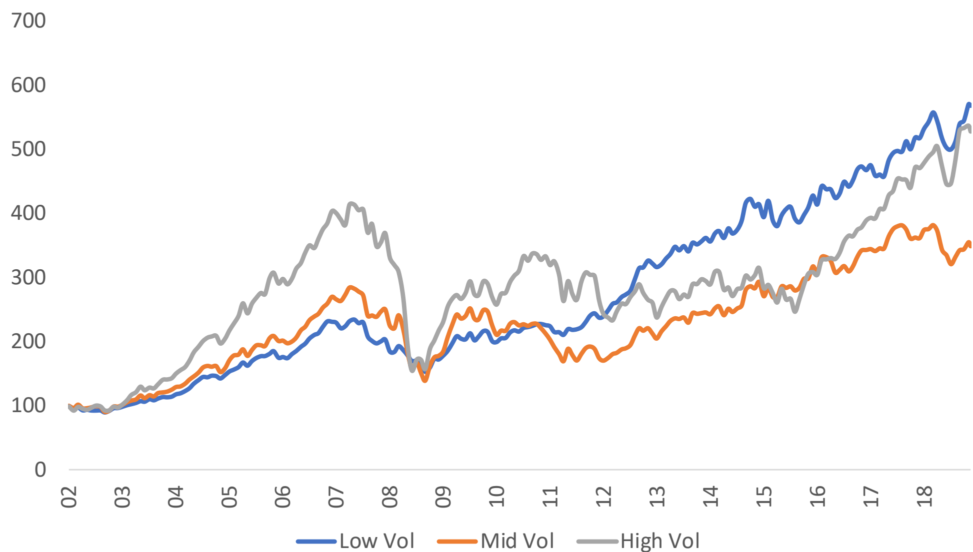
Figure 7: Average ASX100 Constituent Returns by “Growth/Return” Terciles, 2002-19



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*

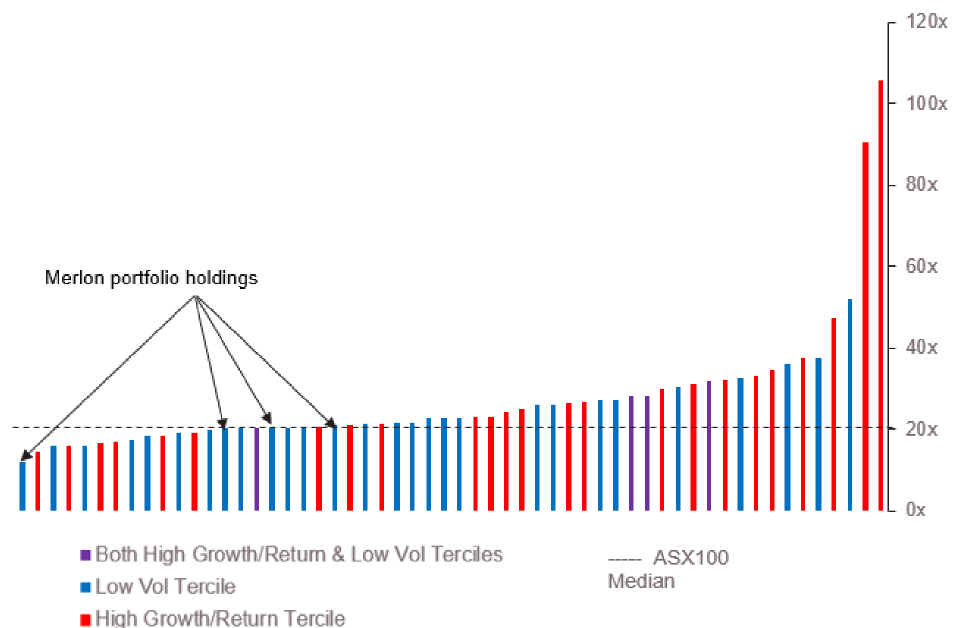
The market often has a short memory. It is easy to look back at the ten-year bull market and conclude that owning "high quality" companies is an easy route to investment outperformance. Yet there is little evidence that this strategy, in isolation, works over the long-term and through the fluctuations 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 10).

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.

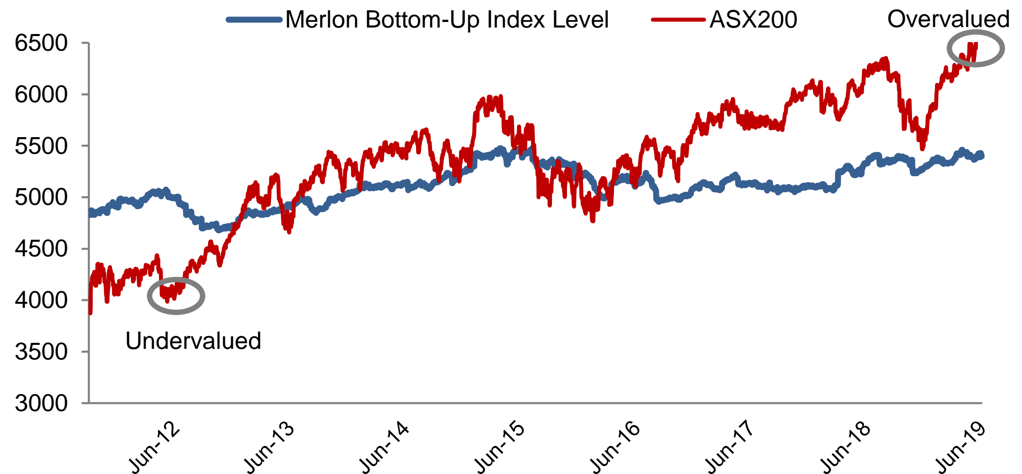
Market Outlook and Portfolio Positioning

Neil Margolis

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

As has been our historic practice, we continue provide an aggregate assessment 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.

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.

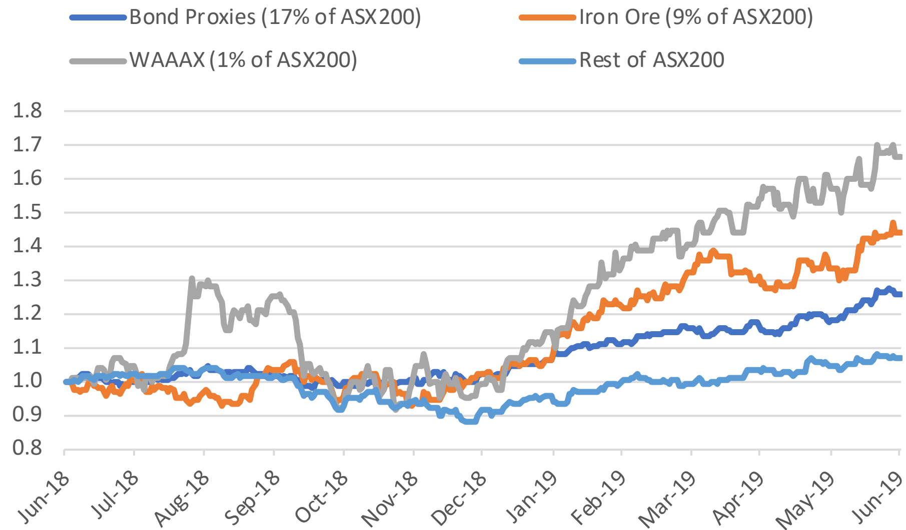
In addition to being less volatile, Merlon's consistent valuation approach across all companies also gives insight into where the market is overly concerned or overly complacent with regard to stock specific risks. This lens on valuation dispersion is more useful than trying to predict when and if the 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 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)

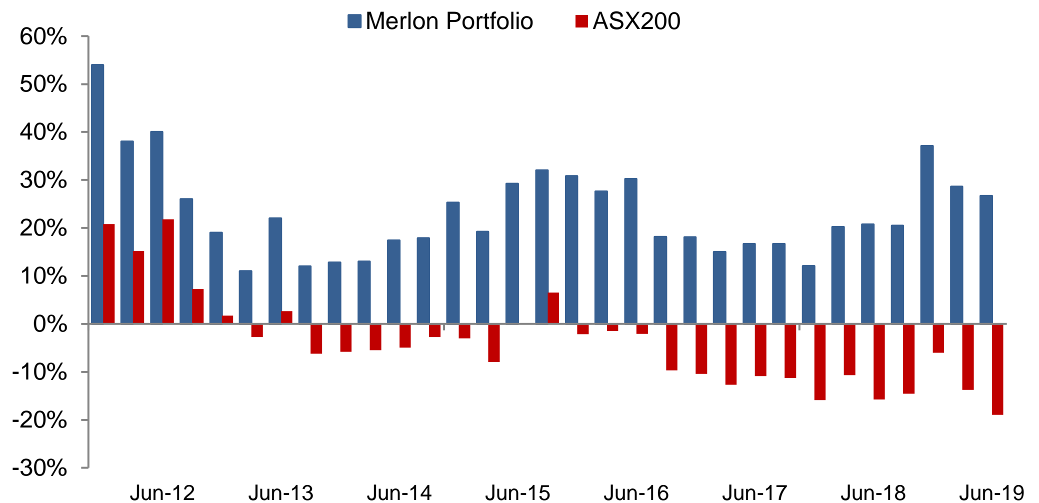


Source: Bloomberg, Merlon analysis

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 are 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.

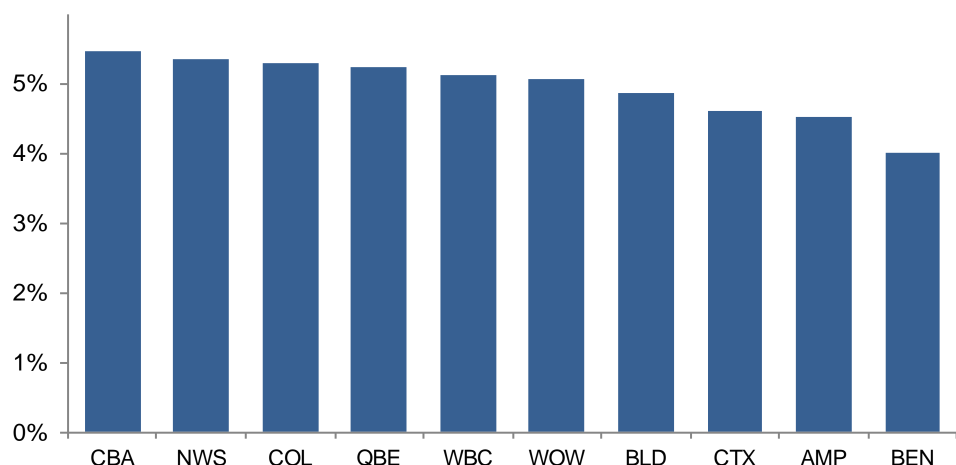
While recent interest rate cuts, tax cuts and macro-prudential easing should benefit the consumer and the housing market, this is against the tide of low wage growth, softening employment conditions and lower major bank risk appetite. That said, we believe on balance that much of this caution is reflected 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 comprises undervalued businesses based on sensible interest rate and risk margin assumptions…

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

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.

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.

Commonwealth Bank, **Westpac** and **Bendigo Bank all** featured in our top 10 holdings at the end of June 2019. We are a non-benchmark investor and unlike many other managers are under no compulsion to own the major banks simply because they represent a large part of major sharemarket indices. Relative to their overall lending assets, the banks are under-earning relative to long term historic norms even after adjusting for recent wealth management divestments. Despite the perceived disruption from “fintech” and the recent Royal Commission we see little evidence of market share loss in the core transactional banking activities. Some loss of lending market share amongst the major banks is not uncommon later in economic cycles and should not in our view be attributed to “disruption”.

Concerns about residential property prices have been overplayed in our view against the continued backdrop of favourable tax treatment and the low interest rates that, ironically, are being used by many investors to justify the ever increasing prices being paid for commercial property and “bond proxy” stocks.

Newscorp remains a significant position in the fund. This is a stock plagued with concerns around governance, the structural decline in print media and competition in the subscription video market from Netflix, Stan and Amazon (among others). All these concerns are valid in our view but need to be weighed up against a share price that assigns no value to any of the affected businesses.

Coles and **Woolworths** both feature in our top 10 and are attractively priced both in absolute terms and more so relative to other “defensive” sectors that are included in our “bond proxy” index discussed above. We believe these businesses operate under an umbrella of a sound industry structure, provide long term inflation protection and are modestly under-earning.

QBE Insurance Group also remains a significant holding in the fund. 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. A return to positive real 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. Alternatively, if bond markets are correct and we move into a deflationary environment, QBE’s longer term claims liabilities will benefit. Management is now more

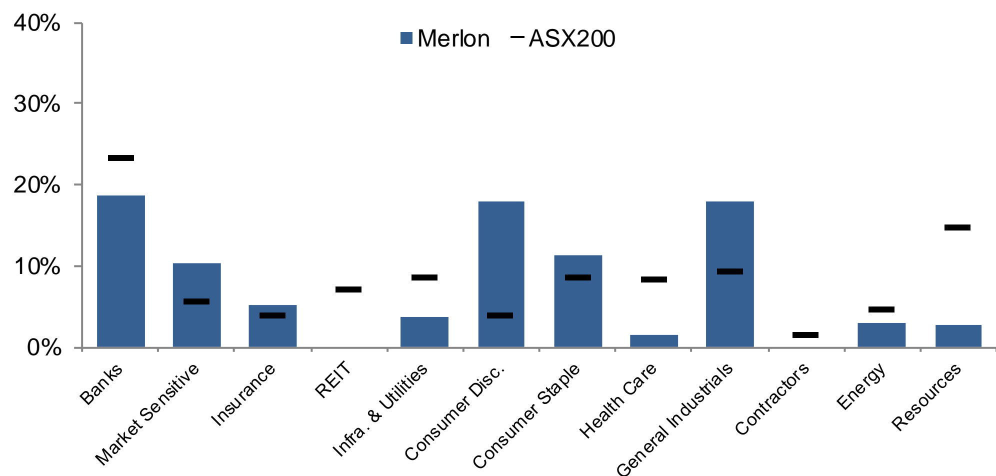
focused, and the insurance pricing cycle appears to be improving, or at least no longer deteriorating.

We increased our existing position in **Boral** which underperformed further on cyclical concerns of a residential construction slowdown in Australia and the US. We believe current expectations are overly cautious given US building starts that are still deflated compared to long term demand and leading indicators in Australia that are beginning to turn positive.

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 spot refining margins begin to improve, which has yet to be reflected in Caltex's financial results nor 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.

AMP continues to feature in our portfolio notwithstanding continued concerns about the fallout of the Royal Commission on the company's financial advice businesses. We believe our investment in the company is underwritten by value outside the financial advice businesses consisting net asset backing, AMP Bank and AMP Capital Investors.

Figure 14: Portfolio exposures by sector (gross weights)



Source: Merlon

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Figure 15: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	33	200
Active Share	75%	0%
Merlon Valuation Upside	27%	-19%
EV / EBITDA	7.9x	12.7x
Price / Earnings Ratio	14.9x	18.0x
Price / Book Ratio	1.9x	6.3x
Trailing Free Cash Flow Yield	5.6%	4.3%

Source: Merlon

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 (vs 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.

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Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)
Portfolio Return (inc. franking)	1.2	5.7	8.4	8.4	12.9	11.0	15.0
ASX200 Return (inc. franking)	3.7	8.2	13.2	13.2	14.4	10.4	13.5
Excess Return*	**-2.6**	**-2.6**	**-4.8**	**-4.8**	**-1.5**	**0.6**	**1.6**

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

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 portfolio increased in value by 5.7%, underperforming the ASX200 by 2.5%. The fund's non-benchmark construction basis means that it will be structurally underweight larger index constituents which represented a headwind for the quarter.

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

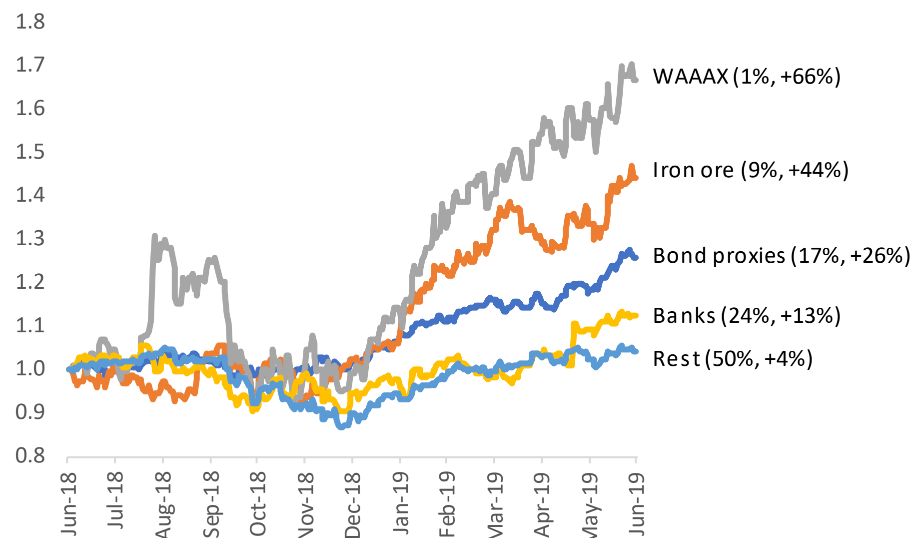
2019 Financial Year Market & Portfolio Review

The funds performance over the year was pleasing…

…and was achieved without speculating about short term dislocations

The June quarter brought to an end Merlon's ninth year of operations and the strategy's 8th consecutive year of positive returns with the fund up 8.4% (including franking). The fund lagged a very strong equity market led by tech stocks, iron ore miners, bond proxies and more recently banks.

Figure 16: 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% as 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%.

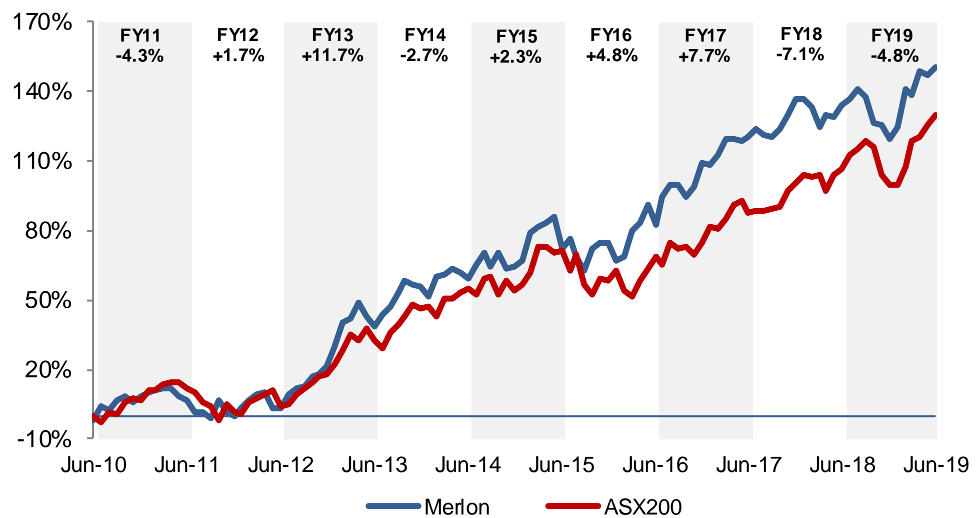
Longer Term Context

Longer-term, the Concentrated Value Strategy has outperformed by 1.6% per annum over the past 7 years, with positive underlying stock selection enhanced by being structurally underweight the mega large capitalisation stocks. 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.

Stock selection outcomes have been positive over longer-term periods

Performance contributors over the long term have been broad-based, with **Magellan Financial**, **Tabcorp**, **Macquarie Bank** and **Pacific Brands** the key contributors. Key detractors over this time frame include **AMP**, **Seven West Media**, **Caltex**, **Sky TV New Zealand** and **Worley**.

Figure 17: Cumulative total returns



Source: Merlon

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Strategy FUM	Merlon FUM
$1,448m	$1,460m

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"

Links to Previous Research

- Iron Ore is Well Above Sustainable Levels
- Some Thoughts on Australian House Prices
- Value Investing - An Australian Perspective: Part I
- Value Investing - An Australian Perspective: Part II
- Value Investing - An Australian Perspective: Part III
- Some Thoughts on Asset Prices
- Rethinking Post Retirement Asset Allocation
- Trade Wars and the Peak of the Chinese Growth Model
- Housing Cracks Present Material Opportunities
- Iron Ore: Supply Disruption is Temporary
- Boral's High Priced Acquisition of Headwaters
- Amazon Not Introducing Internet to Australia
- The Case for Fairfax Media Over REA Group
- Telstra Revisited
- Oil: The Cycle Continues
- Digital vs. Traditional Media - A Global Trend
- Amazon Revisited - Muted Impact So Far
- Some More Thoughts on Telstra
- Asaleo Divestment Well Received
- A Case Study in Poor Capital Allocation

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.

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