Merlon Concentrated Value Strategy

Quarterly Report

December 2019

Contents

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Trade war – winners, losers and…is it over?

Key points

1. **Trade war risks appear to be easing:** A 15 January official signing of the phase 1 trade agreement could signal the end of the escalation phase of the trade war, and lead to an unwind of the notable commodity trends seen over the period.
2. **Longer-term dynamics are unaffected:** While the trade war has had a negative impact on trade activity, commodity performance has been largely overwhelmed by supply issues. Yet our long-term gold, oil and iron forecasts are unchanged.

Figure 1: global merchandise trade growth (y/y)

Source: United Nations Conference on Trade and Development, Calculations: Merlon Capital Partners January 2020

3. **Gold:** Due to its role as an alternative currency, gold has benefited from the US Federal Reserve's (Fed's) cushioning policy stance. The performance of gold is expected to revert towards long-term averages as the Fed reverts to its prior 'normalisation' process.
4. **Oil prices are expected to be supported at higher levels:** Oil has been flat over the course of the trade war, yet the rise of capital discipline in US shale is expected to support prices at or above long-term averages.
5. **Iron ore prices are elevated any way you look at it:** The impact of the trade war on iron ore has been more than offset by supply disruption. Pricing should continue to revert as supply returns.

The Merlon process and commodity stocks

At Merlon, we believe people are generally motivated by short-term outcomes, overemphasise recent information and are uncomfortable having unpopular views. Our process is aimed at ensuring we minimise our exposure to these behavioural biases and exploit misperceptions about risk and future growth prospects.

Commodity stocks are a good illustration of Merlon's process …

The first step in our process is determining sustainable free cash-flow, with reference to qualitative considerations, macro and cyclical considerations and financial returns with as long-term and historic context as possible.

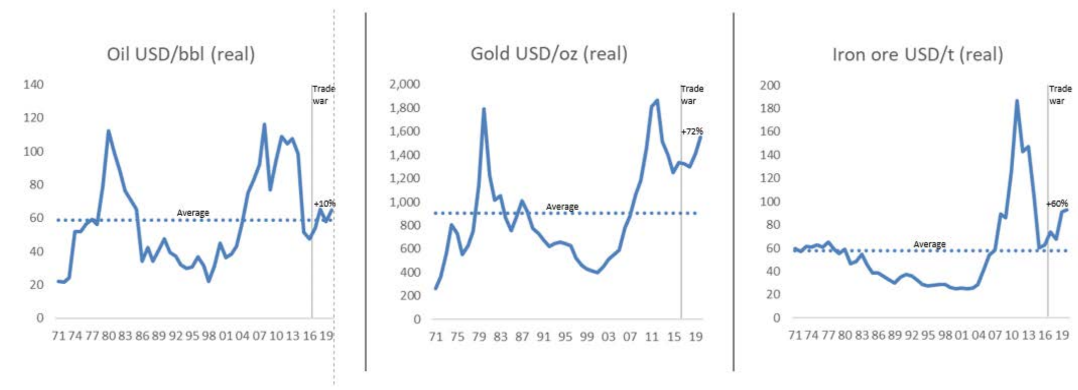
Commodity exposed stocks generally fare poorly in terms of undifferentiated product, high capital intensity and pro-cyclical capital allocation track record. In 2018, we argued a quick resolution to the trade war was unlikely, but the more important driver was unfavourable long-term supply / demand dynamics in our most critical export, iron ore.

The second step is to determine an unbiased and consistent measure of value based on sustainable free cash flow and franking, net of debt. This allows us to determine whether there is some chance other investors have become too concerned (or complacent) about risks and growth.

We then shift our focus to conviction, which recognises that to be a good investment, we need evidence that the market's concerns are either priced in or invalid. One way we determine whether the market is overly pessimistic is to produce valuation scenarios focused on the risk of permanent capital loss relative to the best case or upside scenario. Again, commodity exposed stocks are well catered for in our process given the undifferentiated product and the long-term historical context available to assess a range of plausible valuation outcomes.

… with a long history of over-extrapolation and mean reverting prices

Figure 2: Trade war in the context of long-term pricing (real)



Source: Bloomberg, Calculations: Merlon Capital Partners January 2020

The trade war background and context

In the context of Merlon's process, the trade war did not impact our assessment of sustainable free cash-flow or unbiased long-term value for commodity-exposed stocks. However, it did present downside risk to economic growth and might have resulted in higher conviction if investors became overly concerned and commodity prices sold off from their elevated starting point. This did not prove to be the case for reasons we will explain later.

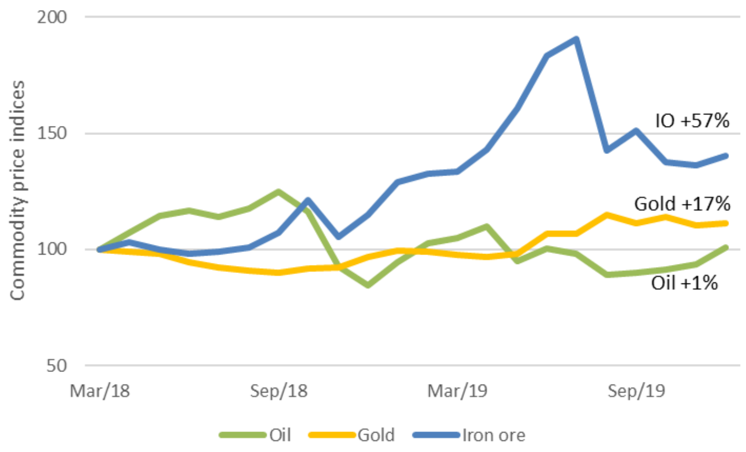
President Trump rewrote the geopolitical narrative with his April 2018 declaration of tariffs on USD50b of imports from China. Since this time, we have seen an escalation phase, which only ended in mid-December. While the effect on commodities was broadly expected to be negative, we have seen significant divergence across the major industrial, energy and precious metal markets.

A phase 1 trade deal would signal an end to trade war escalation

The December trade agreement, if confirmed at the stated 15 January 'official signing', would signal the end of the escalation phase of the trade war. The confidence this gives the global economy, coupled with the lower 'cost of trade', could see increased economic activity. Given the trade war was characterised by declining bond yields and oil prices, and rising gold prices and the USD, it is reasonable to expect some reversal of these trends. This could accelerate should the 'phase 2' talks prove productive.

Phase 1 Trade Deal: proposed tariffs on USD156b of imports from China not enacted; a halving of tariffs on USD120b of imports from China (enacted in September); and a pledge from China to increase largely agricultural-based imports from the US.

Figure 3: Commodity price indices since trade war commenced



Source: Bloomberg, Calculations: Merlon Capital Partners January 2020

Gold: what are you buying?

Price summary:

- Return during trade war: +17%
- Price vs long term average: +72%

Source: Bloomberg: Calculations: Merlon Capital Partners January 2020

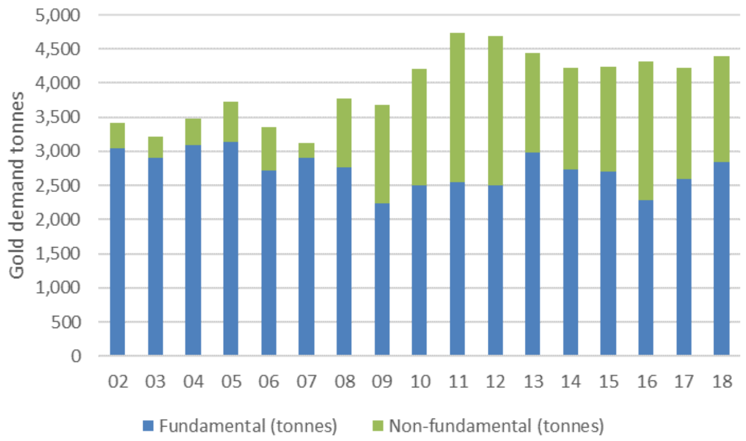
Trade war impact: The trade war has had the most direct impact on gold, with Trump pressuring the US Federal Reserve into a more supportive monetary policy stance, to counteract the negative impact from the trade war. By lowering the opportunity cost of holding gold, measured in terms of the real risk-free rate of return (US treasury yield less inflation), gold has appreciated.

Longer term considerations: Gold is held for different reasons through time, rendering forecasts inherently unstable. Forecasting is complicated by the fact that gold has no yield to reward holders for risk, and hence possesses no inherent value on its own.

The long-term outlook for gold is complicated by increasing non-fundamental demand…

Demand for gold in 2018 was 4,400 tonnes. Of this, fundamental demand (primarily jewellery) accounted for two-thirds of demand, while non-fundamental demand (gold bars and coins, exchange traded funds, and central bank buying) accounted for the remaining third. Non-fundamental demand is more than three-times the levels of the early 2000s.

Figure 4: Components of demand



Source: World Gold Council, Calculations: Merlon Capital Partners January 2020

Non-fundamental demand for gold is considered speculative, as gold does not produce cash flow from which to value it. It is reliant on being able to sell it to someone else in the future at a higher price in order to generate a return. Estimating this non-fundamental component tends to be poorly defined, with a range of factors identified as potentially driving demand.

…but this demand could turn into supply when investors become less concerned about growth and risk

The risk in relying on this non-fundamental component of demand is that when monetary policy normalises, and the global economy proves it is robust in the process of normalisation (a process recently interrupted by the trade war, as previously noted) then this demand may become supply as the reasons for holding gold dissipate. The accumulated tonnage of post

GFC non-fundamental demand represents ***more than five years of fundamental demand***, and should be thought of as latent supply, should the prevailing views change.

Given these risks, it is worthwhile seeking to understand the nature of this non-fundamental component. As a framework for assessing these non-fundamental factors, gold can be thought of as a zero coupon, non-sovereign risk exposed bond. To this end, the appeal of gold is a function of its relative appeal to competing investments, namely sovereign bonds, based on yield, inflation protection and risk of repayment. Each of these elements is discussed below.

The relationship between gold, interest rates and inflation has been unstable through time

Yield: Recently, the dominant narrative for holding gold is the decline in real yields available on benchmark risk-free assets, namely the 10-year US Treasury bond. The argument in favour of holding gold is that the lower the interest rate available on US Treasuries, the more attractive a zero yielding alternative risk-free asset such as gold.

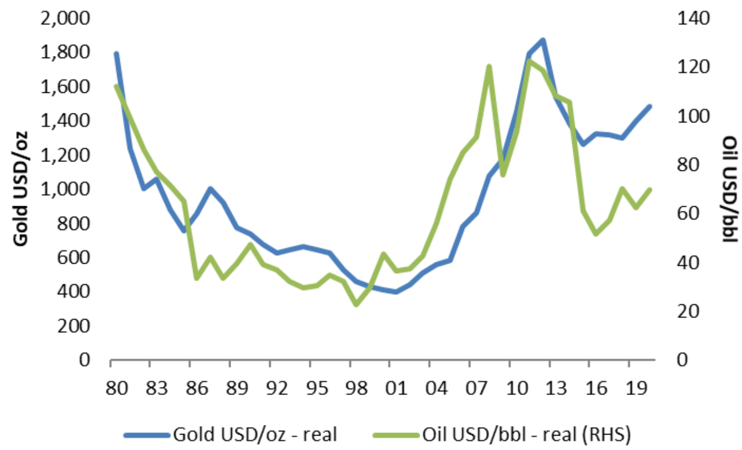
While this argument has played out over the short term, particularly as real bond yields have gone below zero, for most of the period under analysis, the gold price declined at the same time as real yields. In this sense, the ability to rely on this relationship is tenuous.

Figure 5: Gold vs yield (adjusted for inflation)

Source: Federal Reserve Bank of St. Louis. Calculations: Merlon Capital Partners January 2020

Inflation protection: Inflation erodes the value of savings, with gold's apparent scarcity making it seem a useful hedge against inflation. This effect is clear when comparing gold with oil, historically a key driver of inflation.

Figure 6: Gold vs oil

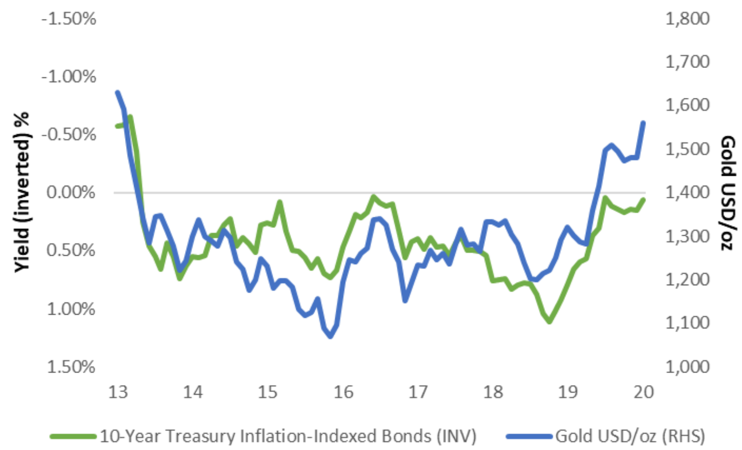


Source: Bloomberg, Calculations: Merlon Capital Partners January 2020

Oil and gold represent a much stronger relationship than that between gold and real yields. While the linkage between oil and gold dislocated in 2014, as the surge in US supply from unconventional sources (discussed below) surged.

Over this period, gold prices have become negatively correlated with real interest rates (rather than positively as they had been for several decades). This is in part due to the opportunity cost of holding gold being lower.

Figure 7: Gold vs US real interest rates recently



Source: Federal Reserve Bank of St. Louis, Calculations: Merlon Capital Partners January 2020

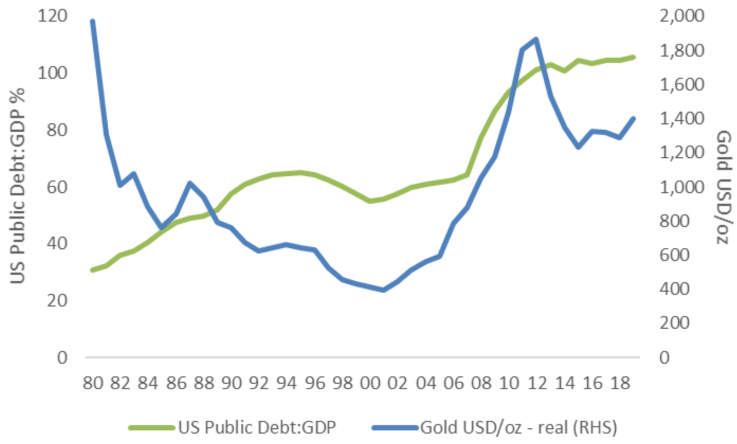
Yet this relationship is still relatively new, and brief in the context of longer-term analysis. And with gold already looking expensive on this basis, and relative to oil as noted, the risks are growing that should interest rates begin to normalise on easing trade tensions, gold could retrace.

Counterparty risk: While gold can be thought of as a type of nil-coupon bond, the counterparty is the market rather than a sovereign, with the principal being the price paid.

Unlike a bond, there is no fixed maturity or amount receivable upon maturity. A holder of gold is at the mercy of the market's pricing of gold at the time of selling.

That said, with the counterparty to US treasuries becoming increasingly indebted, the appeal of gold's counterparty risk is evident. Gold's appreciation is consistent with the rise in US government debt following the GFC. Again, however, this relationship is not a constant one. Should the Fed return to its process of monetary policy normalisation, the arguments for holding gold reduce.

Figure 8: US Public debt vs GDP



Source: Federal Reserve Bank of St. Louis, Calculations: Merlon Capital Partners January 2020

Gold as a currency: People buy gold as if it were a currency, or directly exchangeable as a currency (as it had been for many years prior to the creation of fiat currencies), if they expect the value of their own currency to decline (due to a rise in the prices of goods and services, or due to a rise in the supply of that currency seen throughout the phase of Quantitative Easing policy).

Printing money in excess of the growth of an economy reduces the value of a unit of that currency, making the price required for goods rise to compensate. This was the theory behind Quantitative Easing. Except inflation did not eventuate (or maybe it warded off deflation). Yet the value of the USD as measured by other currencies, has yet to fall.

The risk/reward investing in gold appears skewed to the downside

Conclusions: Our philosophy recognises people tend to over-extrapolate recent conditions. Gold is currently trading 72% above its inflation-adjusted long-term average, so on face value it is difficult to have high conviction that prices will rise further. Gold's strong recent linkages to real interest rates on risk free assets provide the best guide to the short-term outlook. Should we see the negative effects of the trade war reverse, and the Fed's accommodative interest rate policy unwind, then gold's outperformance should reverse. Gold's inflation protection role is also a factor, should inflation re-emerge, yet gold is trading well above long term averages. As we will see, oil may prove a better exposure to inflation given its role in the global economy, and the structural factors that may support pricing.

Oil: capital discipline

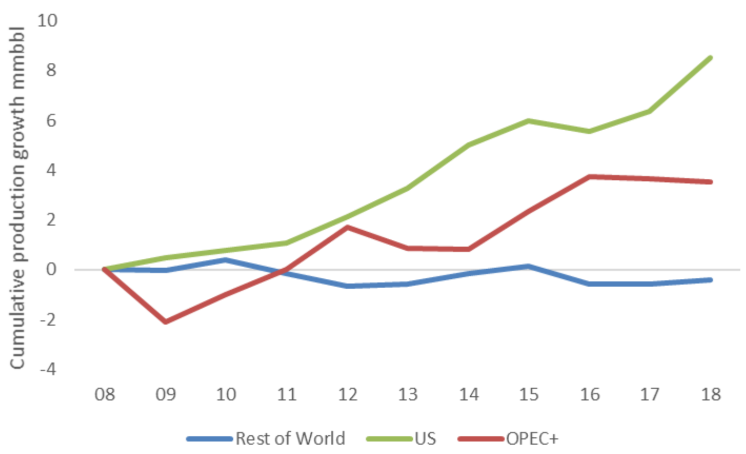
Oil booms have been driven by technology (and capital)

> **Price summary:**
>
> - Return during trade war: +1%
> - Price vs long term average: +10%
>
> Source: Bloomberg: Calculations: Merlon Capital Partners January 2020

Trade war impact: The negative impact of a trade war between the world's two largest economies should have been negative for oil, which has historically been highly correlated with global trade activity. And in terms of demand the effects have been consistent with this expectation, with the International Energy Agency revising 2019 demand growth forecasts down from 1.5mbpd to 1.1mbpd. Yet President Trump's decision to re-apply sanctions on Iranian exports just a month later lent support to pricing, albeit with the market remaining well-supplied via additional supply from Saudi Arabia and Russia, coupled with continued production growth from the US.

Longer term considerations: In short, the oil market has remained pressured by continued supply growth from the US, as the chart below demonstrates. The US has doubled in five years to be the largest producer of oil and associated liquids and has been the most dominant trend in the market over the past decade.

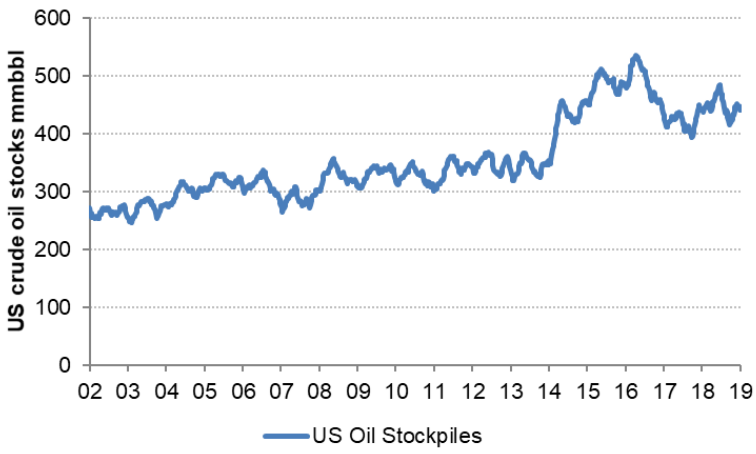
Figure 9: Production change (cumulative mbbl)



Source: BP Statistical Yearbook, Calculations: Merlon Capital Partners January 2020

This rapid growth effectively swamped the US market, leading to a large inventory overhang. In the absence of capital discipline within the US, the response of dominant global producers, most notably Saudi Arabia, was to reduce their own output in order to support pricing, with the objective of enabling the US stockpile to be drained, at least back to their five-year average levels.

Figure 10: US crude oil inventories (mbbl)

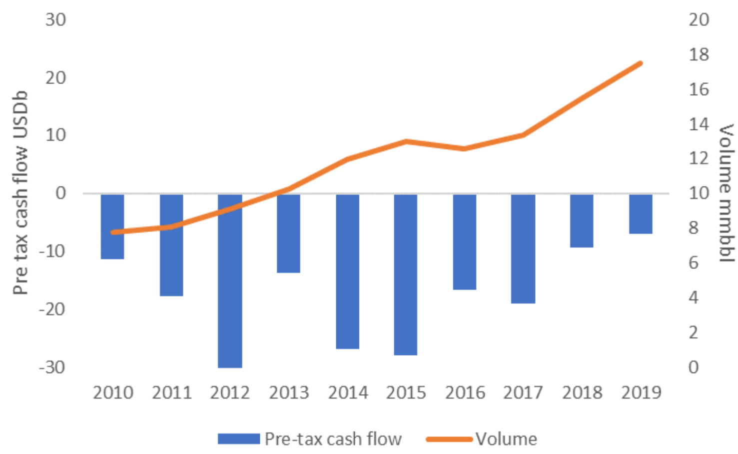


Source: US Energy Information Administration, Calculations: Merlon Capital Partners January 2020

Capital discipline in shale oil is expected to moderate supply

Most importantly for the global market for oil, the ability of the US shale producers to maintain this rate of growth appears increasingly limited, with persistently negative cash-flows leading to declining access to capital to fund further activity. The cash flow from a barrel of shale oil is lower than conventional oil due to significantly higher depletion rates (80% of unconventional oil is depleted in the first 2-3 years).

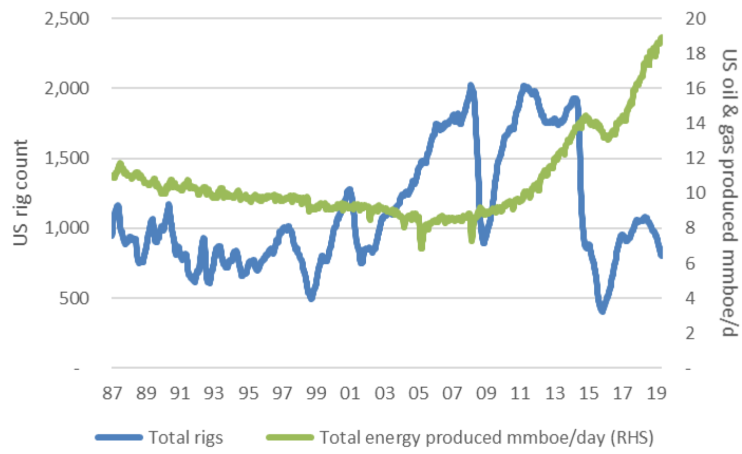
Figure 11: US onshore oil cash-flows



Source: Rystad Energy, Bloomberg, Calculations: Merlon Capital Partners January 2020

The effect of capital discipline is reflected in the below chart, which shows the effect on rig activity. Production has continued to grow following a focus on the most productive plays (effectively high-grading production), yet we expect this substantial decline in activity to ultimately flow through to a peak and potentially declining production. This scenario will be supportive for oil and gas pricing globally.

Figure 12: US rig count (oil & gas)



Source: Baker Hughes (rig count) / US Energy Information Administration (production), Calculations: Merlon Capital Partners January 2020

The risk/reward investing in oil appears skewed to the upside

Conclusions: As noted in the section on gold, we believe oil may prove a better exposure to inflation given its role in the global economy, and the structural factors that may support pricing. We also see the downside risks as being lower, with oil trading only 10% above long-term average levels. With the US being the largest producer of oil and liquids globally, and having dominated production growth over the past decade, the effects of capital discipline in a cash-losing segment are likely to be supportive of prices. Further, the effects of the trade war de-escalation may also result in increased demand growth.

Supply disruption in iron ore is temporary …

Iron ore: disruption reversing

Trade war impact: Iron ore is perhaps the commodity least affected by the trade war. While global steel production (excluding China) has experienced an average -2% growth rate, consistent with the effect on oil markets, China bucked the trend with an average of 7% growth, albeit having recorded a negative year on year growth in October. The net effect on demand has been consistent with oil markets with continued growth, but at reduced rates. Also consistent with oil markets over the trade war escalation phase is the dominance of supply factors, with the key driver of iron ore price being the disruption experienced by the world's top supplier Vale.

Price summary:

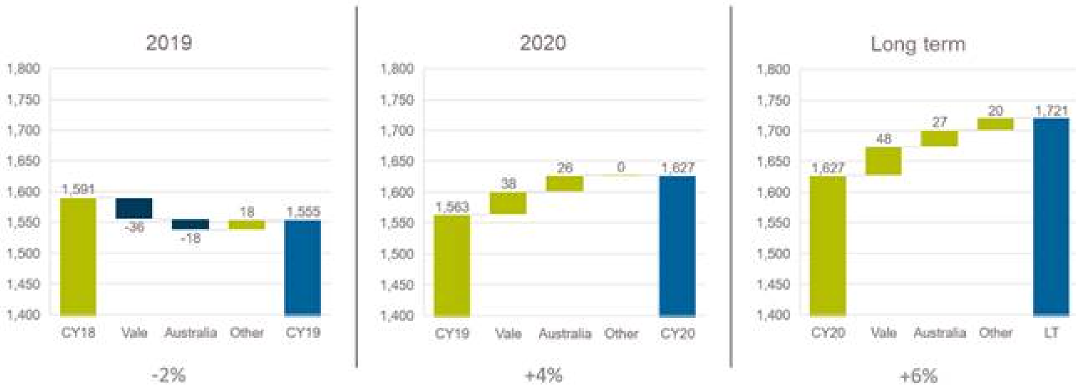
- Return during trade war: +57%
- Price vs long term average: +60%

Source: Bloomberg: Calculations: Merlon Capital Partners January 2020

Longer term considerations:

Supply considerations: Supply growth seems set for more than recovering the outages experienced in 2019, with long term production from the majors 8% higher than levels of 2018, based on recently stated production targets.

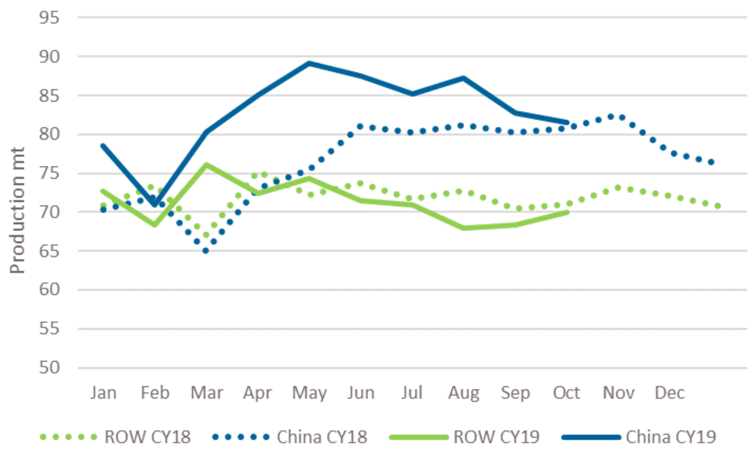
Figure 13: Supply evolution (major producers)



Source: WorldSteel Association, Company Guidance, Calculations: Merlon Capital Partners January 2020

China's steel production in the first half of 2019 was driven by strong 2018 steel spreads following the closure of 'illegal' induction furnace recycling capacity. Yet the chart below shows that this growth may now be tailing off as the effects of oversupply impact producers' ability to sell product. Importantly, it appears that 40% of this growth came via recycled steel, evidence of the growth of recycling within China. Production outside of China is down 2% vs pre trade war levels. Should production continue to follow these trends, the stated iron ore production growth from major producers looks set to push the market into surplus.

Figure 14: Monthly steel production, China vs rest of world (ROW)

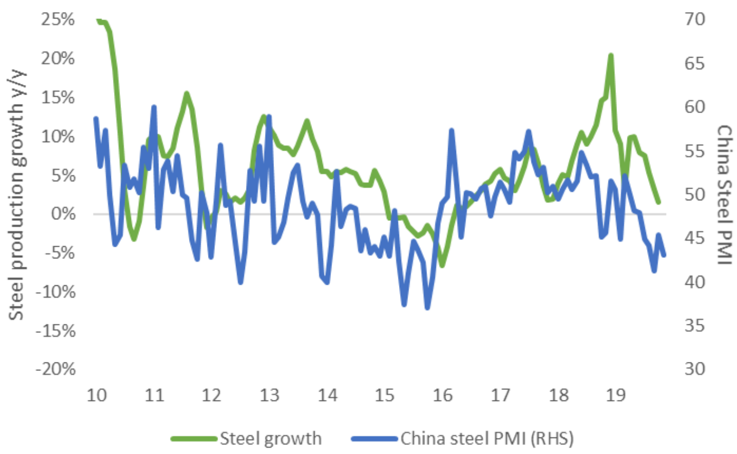


Source: World Steel Association, Calculations: Merlon Capital Partners January 2020

…. but strong iron ore prices could be hiding a weakening China steel market

Yet this growth is clearly excessive, particularly when looked at in the context of the health of the steel industry, as measured by the Steel Purchasing Managers Index (PMI) index. This index shows that while steel production has grown strongly, it has done so in the absence of demand, leading to poor conditions.

Figure 15: China Steel PMI



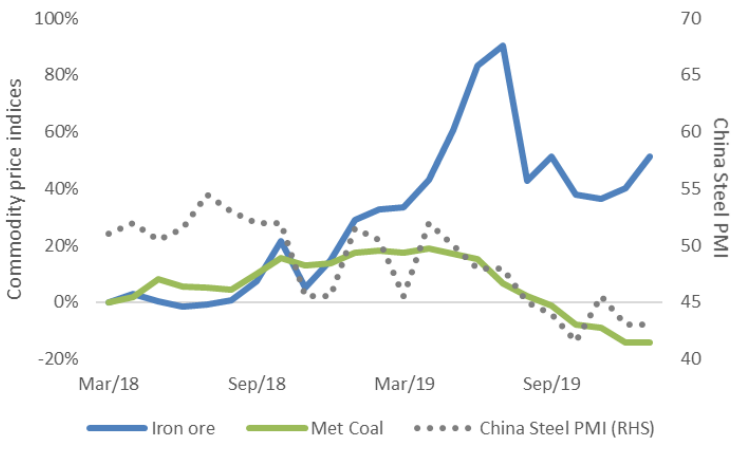
Source: Bloomberg, China National Bureau of Statistics, Calculations: Merlon Capital Partners 2020

The comparison of met coal and iron ore pricing shows that the underlying fundamentals for the steel market may less bullish than that implied by iron ore pricing. While the metallurgical coal market is also exposed to the deteriorating ex-China steel market, its trend remains consistent with China’s steel PMI data, which is noted as deteriorating due to excess production.

Risks are growing in Chinese property

Substitution is a real risk for any commodity

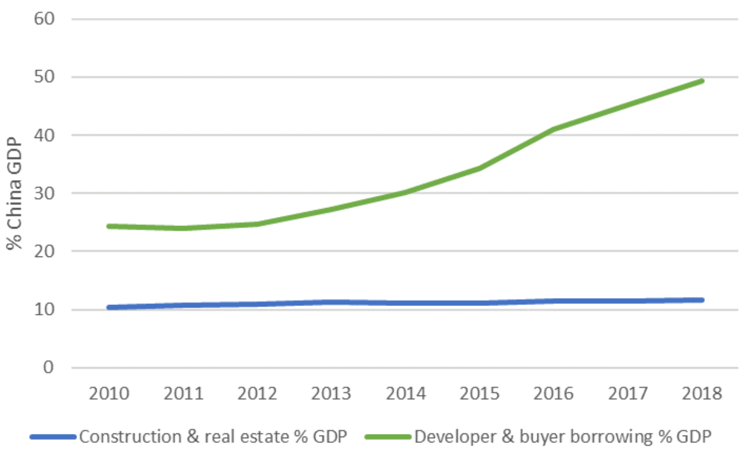
Figure 16: Pig iron input cost comparison



Source: Bloomberg, China Steel Logistics, Calculations: Merlon Capital Partners January 2020

Demand indicators: The contribution of property to the Chinese economy has been stable at 10% since 2010. Yet over this time debt levels have doubled, indicative of unproductive investment in this sector - a feature emphasised by the greater-than-20% vacancy rate. As a key driver of steel demand in China, the growing risk in this sector is a key issue.

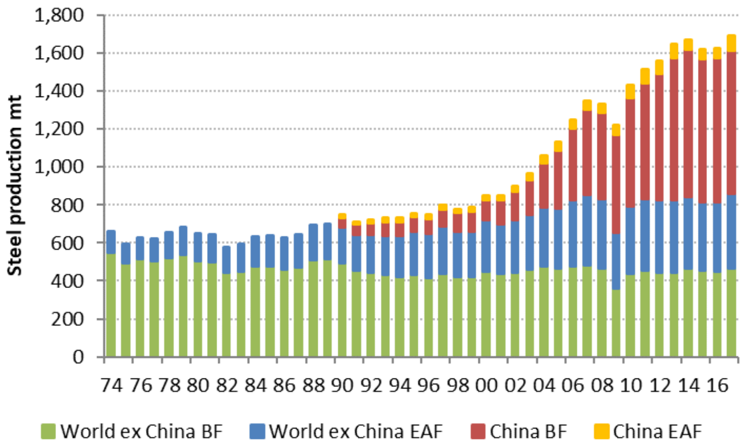
Figure 17: China real estate contribution to GDP



Source: Capital Economics, Calculations: Merlon Capital Partners January 2020

Substitution risk: On a longer-term basis, if China's dedicated recycling rates transition to reflect more mature markets, then the displacement of iron ore from the steel market could be a further negative factor.

Figure 18: China recycling rates low vs rest of the world



Source: World Steel Association, Calculations: Merlon Capital Partners January 2020

The risk/reward investing in iron ore appears skewed to the downside

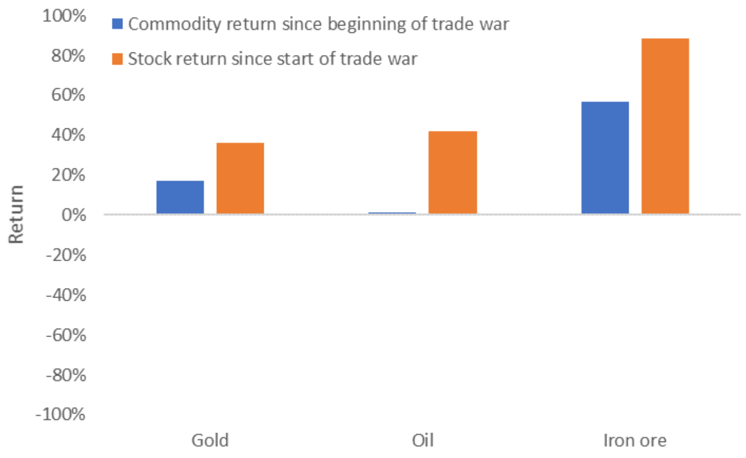
Conclusions: With iron ore, a non-scarce resource globally, trading 82% above its normal level, the downside risks are clear. Vale, being the key driver of supply disruption, is roughly half-way through restoring volumes. China, having been supportive of global demand over the course of 2019 following the positive margin effects of supply side reform, is now at risk of having to reduce the production of steel, seen in recent production data. On a longer-term basis, there is further downside risk from the maturation of its steel industry driving higher rates of recycled steel, and lower usage of iron ore in making steel.

Implications for investors

Investors appear to be complacent about the trade war moderating and iron ore supply returning

While the trade war has dominated the media, iron ore and oil have been more driven by supply side factors. Gold has had the most direct exposure to the trade war given the use of monetary policy to cushion some of the contractionary effects of the dispute. Stocks have exhibited a range of leverage to these commodity price changes, as well as stock specific factors. Oil exposed stocks have been skewed by the corporate interest in Santos over the period, up on average 23% excluding this.

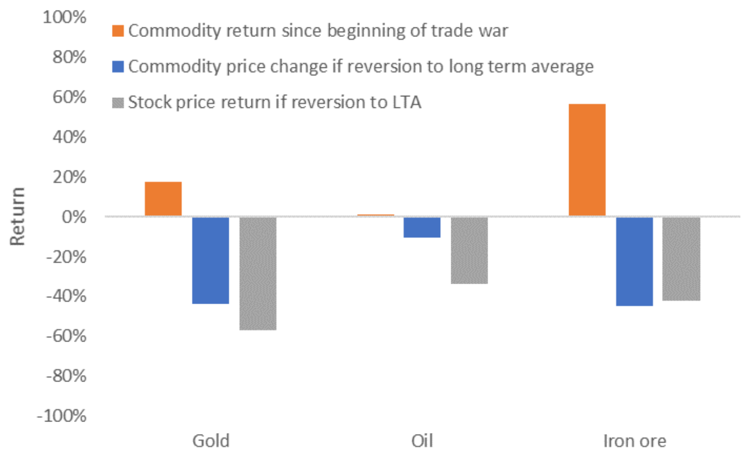
Figure 19: Commodity and stock returns since beginning of trade war



Source: Bloomberg, Calculations: Merlon Capital Partners March 2018 - January 2020

Most pertinent at this stage is to understand the reversion risk should the trade war shift to a 'de-escalation' phase following the Phase 1 agreement. Gold is the most exposed to this given it has been far more directly exposed as noted. Prior to the trade war, the US Federal Reserve had been seeking to normalise policy, with gold prices impacted. Higher global confidence and trade activity would enable the Fed to re-attempt this normalisation.

Figure 20: Reversion risk



Source: Bloomberg, Calculations: Merlon Capital Partners March 2018 - January 2020

Merlon positioning

We are long term investors and are positioned on the basis of sustainable cash flows, which are in turn a function of sustainable commodity prices. The starting point for sustainable pricing is where commodity prices 'usually' trade, calculated as the long-term average price, adjusted for inflation. Structural factors supported by evidence may be overlaid, such as the peaking of US oil production (the largest oil producer) or the shift towards steel recycling in China (the largest iron ore consumer). Following is a summary of positioning with respect to the commodities noted in this paper:

A sensible valuation range suggests risk/reward is skewed to the downside for gold and iron ore…

Gold: With gold 72% above its long-term average, and hence at seemingly unsustainable levels, there is significant downside to our valuation of gold miners. As such we currently have no exposure to this sector. Importantly, even using spot pricing there is an average of ~30% downside in this sector. There are ways to increase the valuation, through using a lower discount rate, a common argument used to justify a higher valuation for gold miners. Yet, even if you believe gold is a risk-free asset, a gold miner has operational and financial risks that do not relate to gold. Further, gold miners are net sellers of gold – they do not hold the asset once extracted. As such, we adhere to our disciplined long-term investing approach.

… but to the upside for oil stocks

Oil: Oil is currently 10% above its long-term average, yet we know a proportion of US shale oil and gas producers are not generating positive cash flows, after capital expenditure required to maintain production. As capital discipline continues to emerge and capital expenditure declines, production should respond. This would be supportive of global oil prices and Australian companies leveraged to this. Merlon currently has exposure to both Origin Energy and Woodside Petroleum.

Iron ore: Iron ore is currently 60% above its long-term average, implying prices are trading well above sustainable levels. With continued iron ore volume recovery as guided by Vale, as well as growth from BHP and RIO, we see supply tightness continuing to loosen. Over the longer term, we also expect to see iron ore displaced as Chinese steel recycling rates increase – a well-accepted path in maturing steel industries. Given these risks, we do not hold iron ore producers.

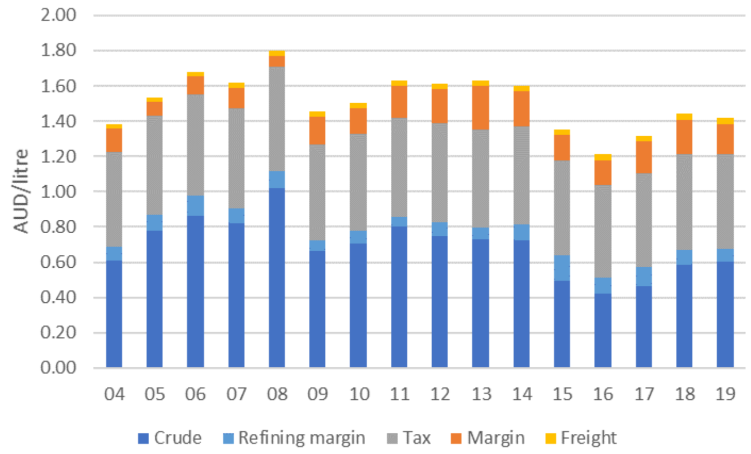
Implications for consumers

Petrol: peaking US production and geopolitical tensions could mean upside risk

Consumers should consider the risk of higher petrol prices…

The most significant driver of the price paid by consumers is the crude oil price, which in recent years, has been affected by the surge in production from the US.

Figure 21: Petrol price builder

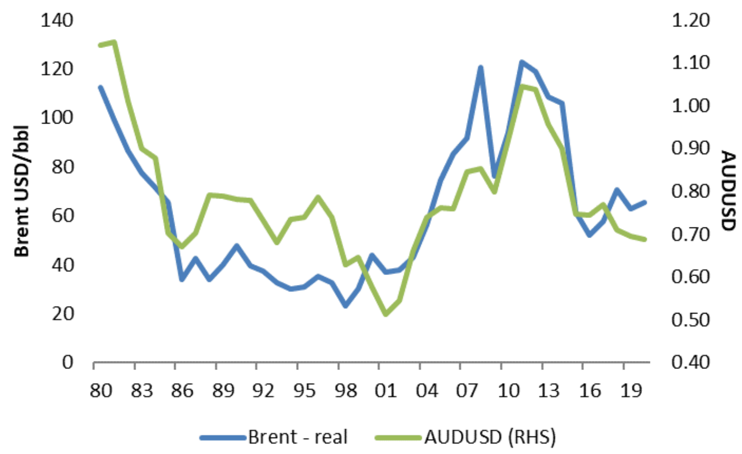


Source: Australian Institute of Petroleum, Calculations: Merlon Capital Partners January 2020

However, the correlation between oil prices and the Australian dollar has been reasonably strong over the long term, serving to dampen the volatility of the underlying oil price. This is because of the common linkage between global demand for oil, and in turn, demand for commodities more generally, of which Australia is a dominant producer.

However, should US oil production begin to decline – an event independent of global demand and hence the Australian dollar – then higher crude oil prices may not be dampened by the currency, feeding directly through to pump prices.

Figure 22: Crude oil vs AUSUSD



Source: Bloomberg, Calculations: Merlon Capital Partners January 2020

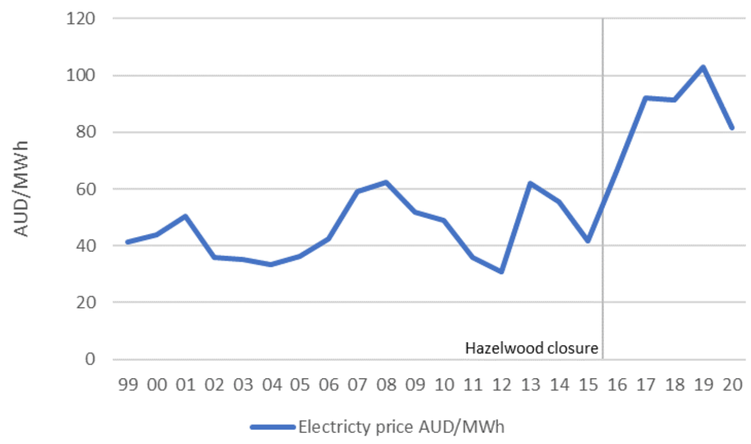
Electricity: growing renewables contribution sees downside risk to prices

Wholesale electricity pricing increased strongly in 2017 following the closure of the large-scale coal-fired Hazelwood plant in Victoria. This closure of baseload generation created a tighter market for electricity and hence, higher prices.

This tightness has begun to unwind, with the growth in renewables capacity. Renewables now contribute 25% of electricity supplied, nearly twice the level five years prior. It is expected that renewables will continue to form a larger part of the electricity mix as further capacity is commissioned.

…potentially offset by declining wholesale electricity prices …

Figure 23: Electricity pricing (NEM average wholesale)



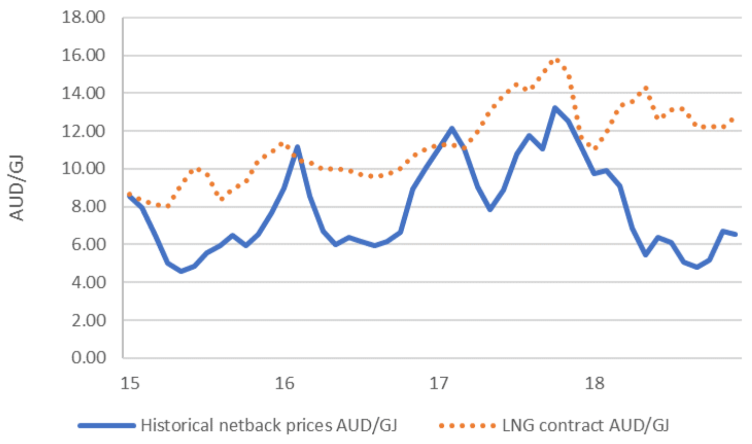
Source: Australian Energy Regulator, Calculations: Merlon Capital Partners January 2020

With more renewable energy comes greater intermittency of generation due to variable weather patterns. This is addressed through greater usage of gas-fired peaking plants, which effectively 'fill the gap' of this intermittency, and hence form the marginal cost producer and price.

Domestic gas prices are increasingly influenced by ACCC-calculated LNG 'netback' pricing (the price received by an LNG exporter in the spot market, less the cost of freight and liquefaction).

While initially gas prices spiked significantly as LNG production in Queensland was commissioned from 2015 onwards, there is now downward pressure on netback pricing, due to an oversupply of spot (non-contracted) LNG cargoes in the region. This is expected to flow through to lower wholesale electricity pricing, albeit typically lagged due to hedging activity. This pricing effect may be exacerbated by renewables capacity growth.

Figure 24: Domestic gas pricing vs contracted LNG pricing



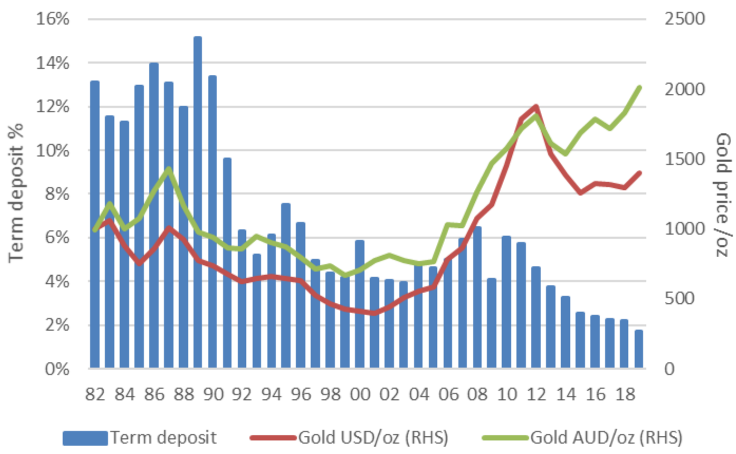
Source: ACCC, Bloomberg, Calculations: Merlon Capital Partners January 2020

Savings: is gold a solution for low interest rates?

Lower savings rates are an issue, particularly if risky investments are pursued

To complete the picture from the other side of the ledger, the ability to generate investment income to pay for these basic commodities has been complicated by declining interest rates. Income from term deposits has basically halved in just five years.

Figure 25: Term deposits vs gold



Source: Reserve Bank of Australia, Bloomberg, Calculations: Merlon Capital Partners January 2020

Some argue that with rates so low, gold becomes more attractive. Yet, a term deposit continues to offer income, relative to the guaranteed zero income provided by gold. To roll a term deposit into an investment in gold, therefore, an investor must implicitly expect the gold price to rise – this is the classic definition of speculation: buying something with the expectation of being able to sell it for a higher price. It is true that gold prices have been rising, however, the negative correlation with declining interest rates is not a consistent relationship through time and not necessarily reliable in future.

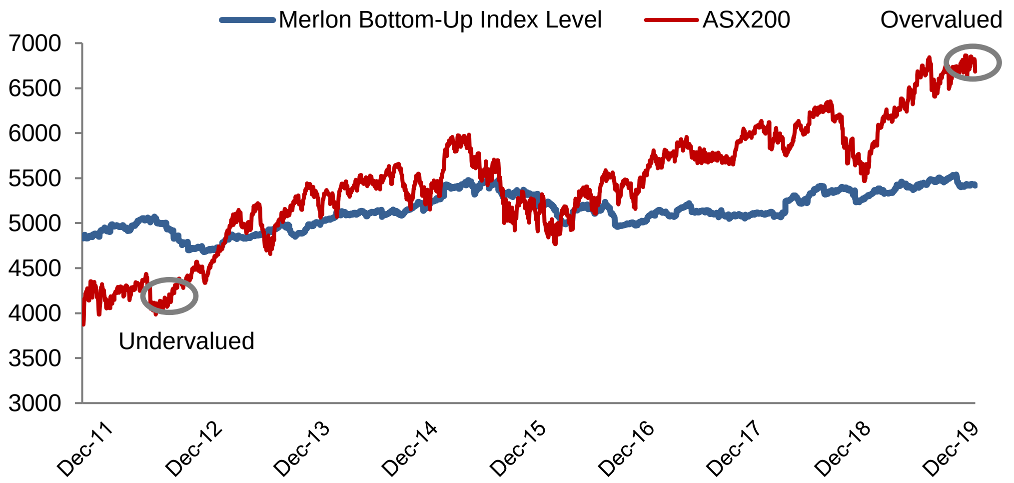
Market Outlook and Portfolio Positioning

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 148 stocks we actively cover. On this basis the market appears approximately 20% overvalued after returning 25% in 2019.

Market approximately 20% overvalued using consistent bottom-up approach…

Figure 26: Merlon bottom up market valuation vs ASX200 level



Source: Merlon

…with the overvaluation concentrated in certain sectors.

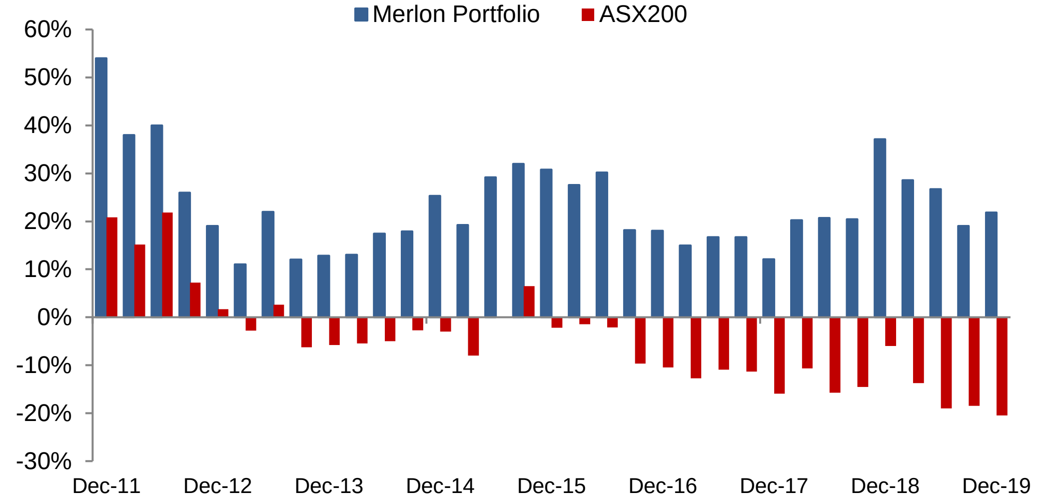
Our individual company valuations have been established utilising our estimates of sustainable free-cash-flows and franking credits, discounted at consistent mid-cycle interest rates and risk premiums. Our valuations are long-term and generally a lot more stable than fluctuating share prices, creating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

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 some of the more excessively priced subcomponents of the ASX200 index, most notably "bond proxies", technology and iron ore stocks, 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 27: Expected return based on Merlon valuations



Source: Merlon

The outlook for interest rates globally appears to be lower with the Federal Reserve having cut rates for a second time, while the Reserve Bank of Australia (RBA) has now cut rates three times, with the official rate now below 1%.

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**, **News Corporation** and **Woodside** should benefit if the Australian dollar weakens further.

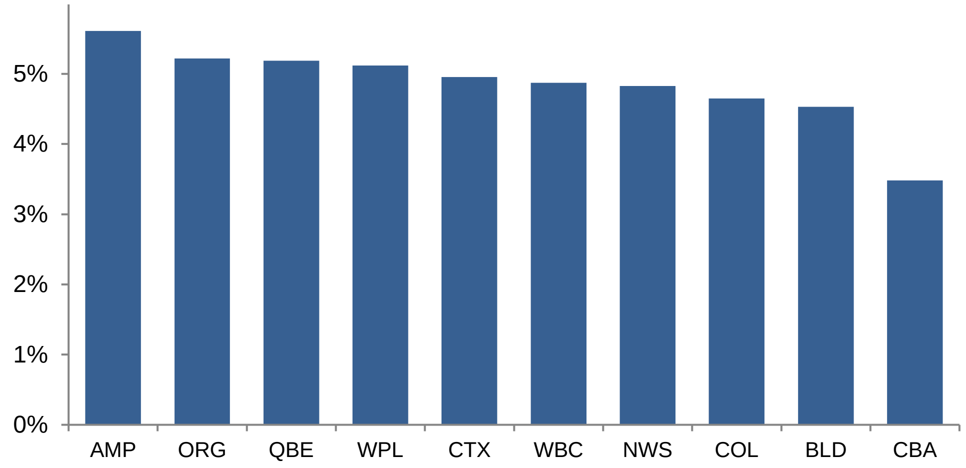
While recent interest rate cuts, tax cuts and macro-prudential easing should benefit the consumer and the housing market, this is against the tide of low wage growth, softening employment conditions and lower major bank risk appetite. That said, we believe on balance that much of this caution is reflected in low market expectations, with select bank and some domestic cyclical companies representing 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 28: 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 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 management manipulated measures of corporate financial performance instead of cash flow continue to present us with opportunities.

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 more than underwritten by value outside the financial advice businesses consisting net asset backing, AMP Bank and AMP Capital Investors (The AMP Valuation Case).

Origin Energy and **Woodside Petroleum** are both exposed to robust LNG portfolios being underappreciated by the market, and an oil price that is not reflecting the likely decline of non-cash generating unconventional US oil production, coupled with the underinvestment in conventional fields. Further, the risks surrounding Saudi Arabia's facilities amidst growing tensions in the Middle East are not reflected in current pricing.

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.

Caltex is an integrated oil refining and fuel supply and marketing company, with a refining business impacted by cyclically depressed refining margins, coupled with the effects of high petrol pricing on consumer demand and Viva Energy seeking to restore some volumes lost during Coles Express 'out of market' pricing. The industry structure has improved though and remains dominated by vertically integrated companies capable of generating margins throughout their supply chain. A recent take-over approach has ignited a new found determination to unlock value through a property IPO and distribution of surplus franking credits.

Coles is attractively priced both in absolute terms and more so relative to other "defensive" sectors that are included in the "bond proxy" group. The company operates under an umbrella of a sound industry structure, provides long term inflation protection and is modestly under-earning.

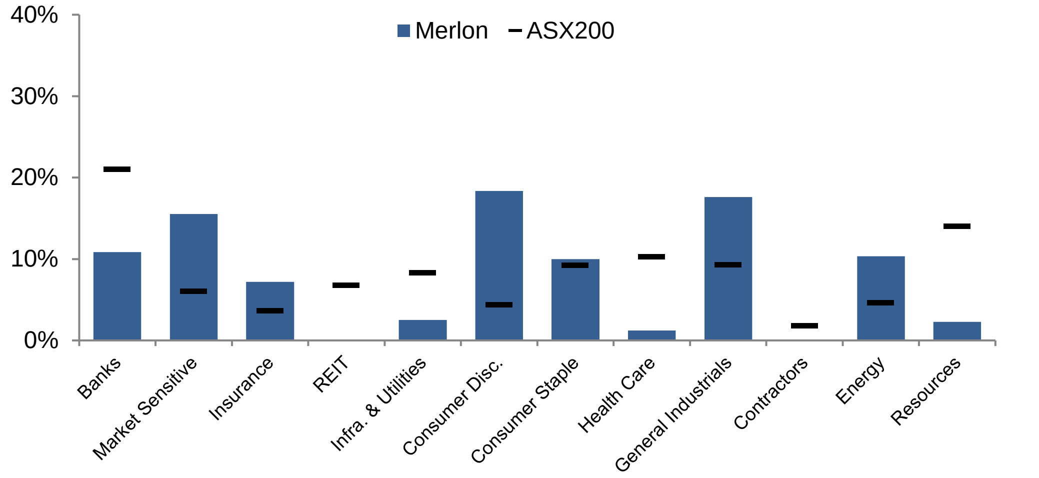
Boral presents good value given cyclical concerns of a residential construction slowdown in Australia and the US. We believe current expectations are overly cautious given US building starts that are still deflated compared to long term demand and leading indicators in Australia that are beginning to turn positive. We are disappointed by recent disclosure of financial irregularities in one of the smaller US businesses, lowering our conviction until we obtain evidence to support management's assertion that it an isolated case.

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.

Westpac and **Commonwealth Bank** (although reduced) both featured in our top 10 holdings at the end of December 2019. We are a non-benchmark investor and unlike many other managers we are under no compulsion to own the major banks simply because they represent a large part of major share market 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".

Further, 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.

Figure 29: Portfolio exposures by sector (gross weights)



Source: Merlon

Figure 30: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	33	200
Active Share	76%	0%
Merlon Valuation Upside	22%	-20%
EV / EBITDA	8.7x	13.6x
Price / Earnings Ratio	17.1x	19.8x
Price / Book Ratio	2.2x	4.4x
Trailing Free Cash Flow Yield	5.5%	4.4%

Source: Merlon

December Quarter Portfolio Activity

During the quarter, we introduced three new investments …

During the quarter we added three new investments albeit all at or below 2% of the portfolio as we build conviction over time.

We invested in **A2 Milk**, a dairy marketing business differentiated through its premium branded A2 product and gaining share in China. The market is concerned about high turnover of senior management, including the CEO, increased distribution and marketing costs and regulatory risks. Whilst traditional accounting valuation multiples look expensive, using Merlon's free-cash-flow approach highlights its superior cash flow generation, growth and balance sheet relative to the broader investment universe. Under a free-cash-flow approach, it suggests investment risk/reward is skewed to the upside under a range of sensible market share and marketing spend scenarios.

We made a small investment in **Bapcor**, one of Australia's largest auto parts distributors and wholesalers. The company is a key participant in consolidation of the fragmented wholesale industry, with upside from exclusive distribution of iconic brands in its repair, trade and retail channels. The market is primarily concerned about weak new car sales and at times irrational competition in the retail segment. However, we expect new car sales to recover with house prices, and in any event, weaker new car sales today will benefit mechanics and the used parts industry in future as the national fleet age rises.

We reinvested in **Suncorp Group**, which has underperformed recently on account of competitive pressures in banking, a slowdown in personal insurance growth, cyclical concerns in commercial insurance and risks around the new CEO transition. However, industry structure remains strong in both core segments, commercial insurance pricing trends are favourable and investment risk/reward is skewed to the upside, particularly if the company's long-term financial targets can be achieved.

We added to the existing investment in **Southern Cross Media** which underperformed and is now trading below our bear case which assumes no value for regional television advertising and metro radio margins deteriorate further from already depressed levels.

… funded by exiting three positions

These investments were funded by exiting positions in **Bendigo Bank**, following a re-assessment of sustainable free cash flow; **BlueScope** which outperformed quicker than expected; and **Virgin Money UK** which we mistakenly reinvested in after nearly halving on the Virgin Money acquisition, but re-evaluated our bear case which presented too much downside risk.

We also reduced but retained investments in **Woolworths**, **Caltex** and **Commonwealth Bank**, all of which outperformed relative to our long-term assessment of value. We also reduced but retained investments in **Fletcher Building** and **Metcash** on account of reduced analyst conviction.

Performance[i] (%)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)
Portfolio Return (inc. franking)	-2.6	1.5	5.9	22.4	9.3	11.4	13.2
ASX200 Return (inc. franking)	-2.2	0.9	3.7	25.0	11.8	10.5	11.5
Excess Return*	**-0.4**	**0.6**	**2.1**	**-2.6**	**-2.4**	**0.9**	**1.7**

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

December Quarter Market & Portfolio Review

The ASX200 gained 0.9% for a fourth successive positive quarter…

Despite retracing more than 2% in December, the ASX200 managed a fourth successive positive quarter, rising 0.9%. Bonds finally sold off with the Australian 10 year yield up 34bp, albeit from record low levels. The Australian Dollar gained 4% reflecting reduced global growth risks from the trade war and Brexit. Sydney house prices gained 6% for the best quarter in more than 10 years.

Healthcare, principally CSL, and Energy & Resources were the best performing sectors. Financials, principally Banks, and Consumer Staples, were the worst performing sectors.

with the Fund outperforming by 0.6%…

Against this backdrop the portfolio returned 1.5% in the December quarter, outperforming the ASX200 by 0.6%. The top performing investment was **Caltex**, following a positive trading update, potential property IPO and take-over offer. **IOOF** also performed strongly after renegotiating and completing the ANZ platform acquisition. Other notable contributors included **Pendal Group** and **A2 Milk**, as well as not holding **NAB**. Key detractors were **Southern Cross Media** on an earnings downgrade, **Boral** on “financial irregulates” in one of its US businesses and not holding **CSL** or **BHP**.

…and strong gains over the past 12 months while remaining true to our philosophy

Over the last year, the portfolio has gained 22.4%, lagging a very strong equity market (up 25.0% including franking), led by healthcare and other growth stocks, iron ore miners and bond proxies. Given our calculated and deliberate positioning away from these sectors, 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.

Magellan Financial (now exited) was the best performing holding, with funds under management growth and performance fees surpassing market expectations. **IOOF** was the second best performing holding, with the position initiated in December 2018, the same day APRA announced licence conditions and intention to disqualify certain directors. Rounding out the top 5 contributors were **Caltex**, finally attempting to unlock shareholder value following a take-over offer, **Coles**, benefitting from a more rational competitive environment, and not owing **National Australia Bank**.

AMP was the largest negative contributor over the year although the diversfied financials sector was a strong positive contributor overall. Not owning **CSL** detracted, with the PE multiple expanding to 45x last reported earnings before interest from 35x a year ago.

Company guidance is for 7-10% earnings growth in 2020. **Boral** underperformed as the Australian building cycle deteriorated and question marks have arisen relating to the US Headwaters business. **Southern Cross Media** underperformed on weak industry advertising conditions and we mistakenly reinvested in **Clydesdale Bank**, even though the share price had already almost halved following the Virgin Money acquisition.

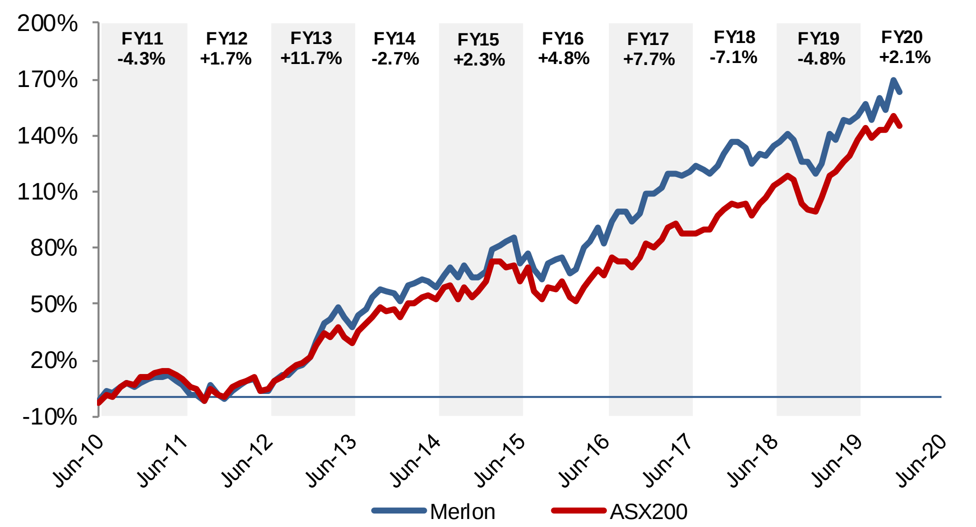
Longer Term Context

Longer-term, the Concentrated Value Strategy has outperformed by 1.7% per annum over the past 7 years, with positive underlying stock selection enhanced by being structurally underweight the very 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**, **Pacific Brands** and **TradeMe** the key contributors. Key detractors over this time frame include **AMP**, **Seven West Media**, **Sky TV New Zealand** and **Worley**.

Figure 31: Cumulative total returns



Source: Merlon

Strategy FUM	Merlon FUM
$1,076m	$1,079m

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

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

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.