Merlon Income Strategy

Merlon Australian Share Income Fund

Quarterly Report

March 2020

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Dear Fellow Investors

On behalf of the team at Merlon Capital Partners, our thoughts go out to everyone who has been directly impacted by the Coronavirus and especially to those who have had to endure the loss of loved ones. The pandemic can be deadly which makes it absolutely critical that we all follow the advice and precautions being put in place to protect the most vulnerable.

There is no shortage of analysis and predictions about when the rate of growth of the virus will flatten out, disruptions will ease, and markets will bottom. We only need to look at how things have developed over the last two weeks to know how speculative such analysis can be and how wrong it can be to compare the experience of Asian countries to what we are seeing in parts of Europe and the US.

What we know is this:

90% of the value of companies is dependent on cash-flows beyond 1 year into the future. It is an unwavering focus on long dated cash flows that forms the foundation of our investment approach.

Times of panic have proven to be the best times to add to equity portfolios. Buying stocks at reasonable levels relative to history has always paid off for the long-term investor. We are strongly cautioning our investors not to do anything rash. In fact, across our team we have added to holdings in our funds and the market.

Temporary losses can be made permanent by panicked decision making or excessive levels of debt. Given the role of debt in exacerbating losses it is no surprise that that some of Australia's most indebted companies have been the most volatile. We comment on the role of debt further below.

We will get through the Covid-19 crisis. There will be a vaccine, herd immunity will develop and ordinary life will bounce back. In the meantime, policy response is already and will be extraordinary and unprecedented. This is a deadly enemy we are dealing with and in the end, we fear, will be remembered more by the human tragedy than the financial losses.

Australia is in a vastly better position to deal with the crisis than the US. We have a better government that is listening to expert advice, bipartisan policy support, a better fiscal position, a stronger financial system and a vastly superior health system.

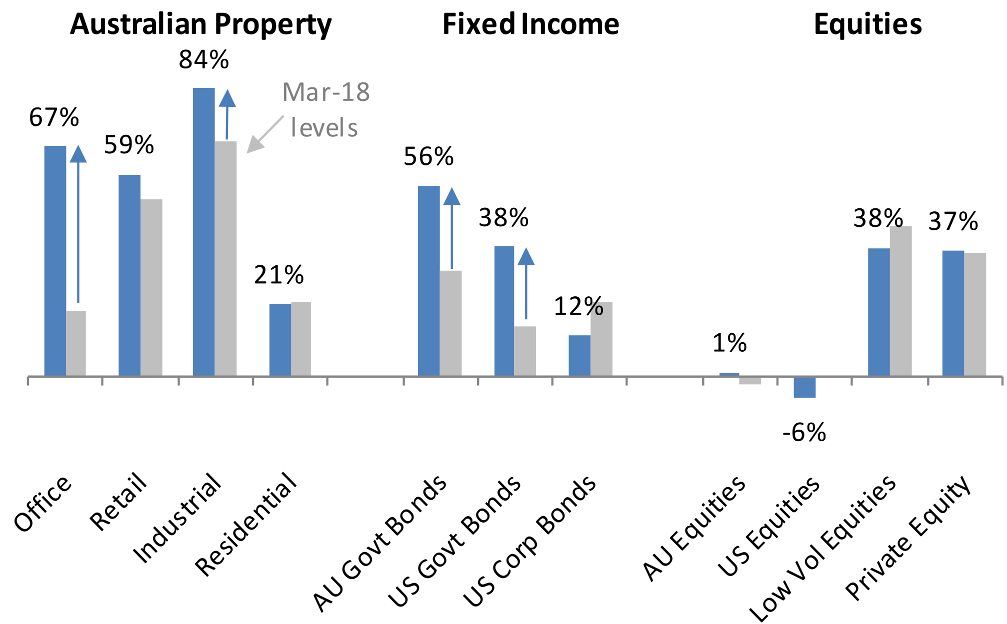
Asset prices were historically high leading into the current crisis. Interestingly the most historically over-valued asset classes have not been punished much more than the market at large so far into this sell-off which has been broad based.

Pre-Covid-19 Asset Prices

Property, bonds & unlisted equity were expensive coming into the crisis…

Property, risky fixed income and unlisted assets had "re-rated" in the years leading into the current episode.

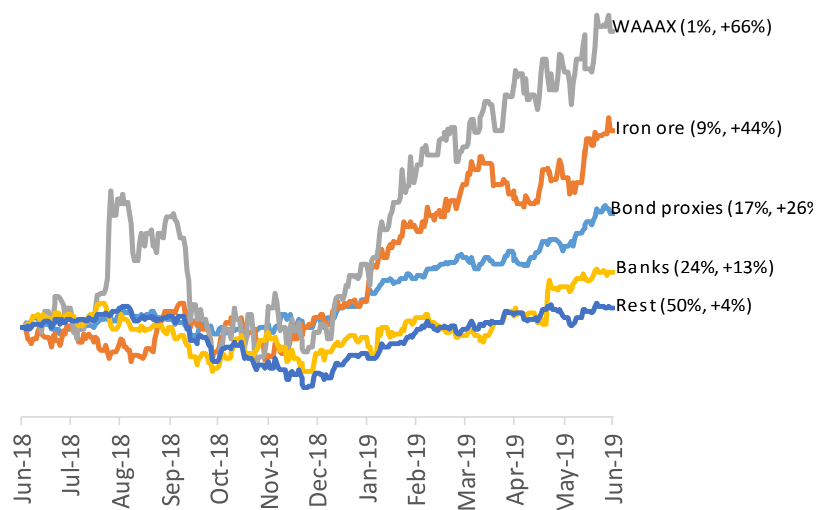
Figure 1: Pre-Covid-19 Asset Prices Relative to Post 1990 Averages



Source: Merlon, Prices as at 13 March 2020

So had the tech sector with record amounts of venture capital chasing ever increasing public market valuations. Investors were treating certain parts of the equity market as "bond proxies" and in doing so were placing a low price on risk.

Figure 2: Drivers of 2019 Financial Year Market Performance



Source: Merlon

Thinking about risk:

We define risk as the risk of a permanent loss of value. The way many professional fund managers and corporate boards think about risk is very different to the way we think about risk. We define risk as the risk of a permanent loss of value, not the risk of short-term share price underperformance relative to a benchmark.

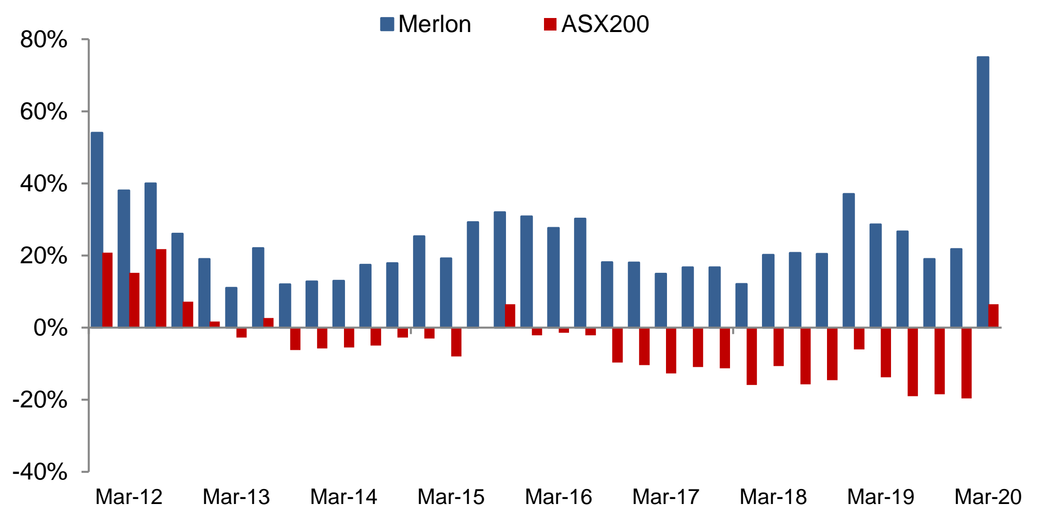
Risk of permanent loss is exacerbated by panic, misaligned incentives and leverage. Panic swings fast from fear of losing money to fear of missing out on the bounce. Professional fund managers and corporate management paid bonuses based on short term performance relative to an index or a peer group are hard-wired to take excessive levels of risk ("heads I win, tails you lose"). Such incentives are grossly misaligned with end investors and simply do not exist at Merlon Capital.

Calls from banks and debt holders can force companies and investors, that in the absence of leverage, would see no long-term permanent loss to be bankrupt. Given the role of debt in exacerbating losses it is no surprise that some of Australia's most indebted companies have been the most volatile in recent weeks.

Our approach to dealing with debt is simple, we take the view that it needs to be repaid. With the exception of banks, which we deal with separately below, for every company in our portfolio and under our coverage we deduct the full value of debt from what we think the company would otherwise be worth.

The risk of permanent loss is mitigated by owning undervalued assets. This is not to say that undervalued assets cannot fall more than expensive assets over short periods of time. In fact, in the current episode the reverse has been true. But in the long term, the market is a "weighing machine" not a "popularity machine".

Figure 3: Expected return based on Merlon valuations



Source: Merlon

Liquidity plays an important role. Unlisted property, infrastructure assets and corporate debt were historically expensive coming into the current episode and already we are seeing valuation mark-downs. When all is said and done, if listed assets are cheaper than unlisted assets investors will sell unlisted assets and buy listed assets. In the long term, the market is a “weighing machine”.

The Hedge Overlay has provided protection to the falls in the underlying share portfolio. The Fund is constructed to deliver a risk profile equivalent to a portfolio with 70% equity exposure and 30% cash exposure. This is achieved by “protecting” 30% of a fully invested equity portfolio using put and call options. The objective is to retain exposure to fully franked dividends over the entire portfolio without taking on undue risk profile.

As it did in the GFC and every other market downturn, the hedge overlay is contributing strongly.

Our portfolio:

Rest assured, our philosophy and process have not changed. We take a long-term view, focus on long-term value based on Sustainable Free-Cash-Flow and weigh up every decision we make against the risk of permanent loss.

In the absence of leverage, the risk of permanent loss is low. Remember, we will get through the Covid-19 crisis. Also remember that for every single investment we made coming into this crisis we fully deducted the debt from our valuations in developing our investment view.

Like every cycle, the property sector came into this episode expensive and leveraged. We came into this cycle without REIT exposure and - with the exception of a small opportunistic purchase this month - we remain largely unexposed. This is not to say we won’t add more exposure but only after fully deducting the value of any debt in developing our investment case.

No companies are more leveraged than the banks. Leverage is the enemy of the investor seeking to avoid permanent loss. The good news for Australian equity investors who in general remain absurdly exposed to the banking sector is that the banks survival is critical to the “whatever it takes” strategy to get through the Covid-19 crisis.

The bad news is this doesn’t guarantee the banks will be good investments. Make no mistake, we will have a recession. And there has never been a meaningful recession in any economy anywhere without bank-failures or near-bank-failures that wipe out equity owners.

At best, there is a non-trivial risk that the banks emerge with significant non-performing loan portfolios and lower profits due to constraints by governments in their ability to enforce security and charge commercial rates of interest and late fees to customers.

We did not hold Macquarie Bank coming into this crisis and have reduced our relatively modest major bank exposure to an immaterial level in recent weeks.

Dry powder. We regard it as sensible to be measured and selective about how we invest through this downturn and currently hold more cash than we have in the past. This is balanced by holdings in fund managers which while their profits are sensitive to market movements their balance sheets are unleveraged, mitigating the risk of permanent loss.

This risk of being too conservative is simply that we might not make as much money as we would have otherwise. But we'll still make money and given the opportunities being thrown up in the panic we'll still probably be better off than we would have been had the Covid-19 crisis never emerged.

Hedge Overlay. The hedge overlay will continue to insulate the Merlon Australian Share Income Fund should the market continue to decline. We do not seek to "time" markets and as such will continue to remove 30% exposure via this overlay.

Alignment:

Rest assured we have considerable amounts of our own funds invested alongside our investors. We also own the majority of our firm. We have added to our own investments in recent weeks because of the amazing opportunities the crisis is presenting for long term investors.

We reiterate, that this is a deadly enemy we are dealing with and in the end will probably be remembered more by the human tragedy than the financial losses. We are working extraordinarily hard – from our homes – to ensure that any financial losses incurred are temporary and not permanent.

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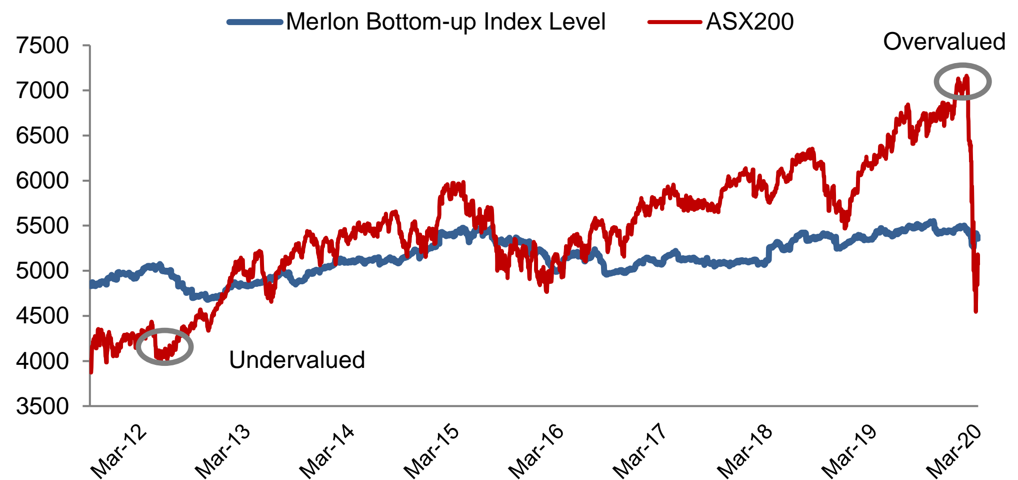
Market Outlook and Portfolio Positioning

Neil Margolis

Market approximately 6% undervalued using consistent bottom-up approach…

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 154 stocks we actively cover. On this basis the market appears approximately 6% undervalued after falling 23% during the quarter.

Figure 4: 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. Merlon's value portfolio comprises our best research ideas, based on our long-term valuations and analyst conviction.

We came into the current crisis with some parts of the ASX200 Index excessively inflated...

Of note is that we came into the COVID 19 crisis with historically inflated subcomponents of the ASX200 Index and historically low corporate credit spreads. 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 well positioned against the recent trend of rapidly inflating asset prices in these areas.

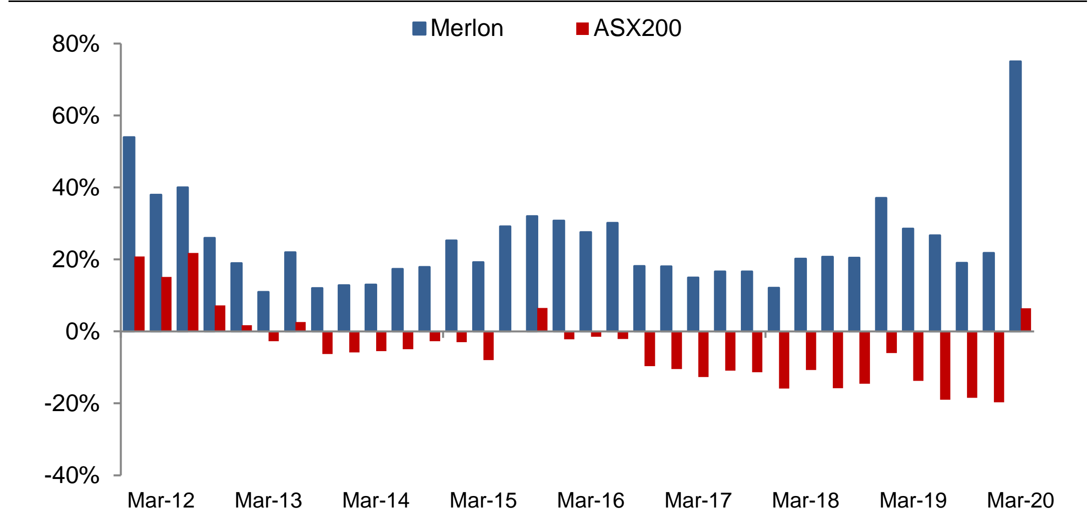
Unlisted property, infrastructure assets and corporate debt are already seeing valuation mark-downs. When all is said and done, if listed assets are cheaper than unlisted assets investors will sell unlisted assets and buy listed assets. In the long term, the market is a "weighing machine".

The risk of permanent loss is mitigated by owning undervalued assets…

Our view is that the risk of permanent loss through the current crisis is mitigated by owning undervalued assets. This is not to say that undervalued assets cannot fall more than expensive assets over short periods of time. In fact, in the current episode that is exactly what has happened. The implication (as seen below), is that the Merlon portfolio offers truly exceptional expected returns compared to the index and in absolute terms.

The Merlon portfolio offers truly exceptional expected returns…

Figure 5: Expected return based on Merlon valuations



Source: Merlon

The short-term outlook is difficult to predict…

The short-term outlook for the global economy, interest rates and inflation is difficult to predict. Despite this, there is no shortage of analysis and predictions about when the rate of growth of the virus will flatten out, disruptions will ease, and markets will bottom. These predictions are all speculative and will all be wrong.

The long-term outlook is easier (but still extraordinarily difficult) to predict. With regards to the COVID 19 virus, there will be a vaccine, herd immunity will develop, and ordinary life will bounce back. This is all at least 12 to 18 months away and in the interim it is difficult to envisage the global economy will operate at anywhere near pre-crisis levels. This is bad news for companies with high levels of debt, high fixed costs, poor management and/or lack of competitive advantage.

The global economy will emerge from this crisis with unprecedented levels of government debt, extraordinarily low interest rates, inflated central bank balance sheets and unprecedented levels of fiscal stimulus. What all this means is difficult to say, but the risks of inflation and currency debasing cannot be discounted.

The portfolio is positioned for a recovery but has elements to protect against a protracted downturn …

In light of the backdrop, we have repositioned some elements of the portfolio. In particular, we have significantly reduced our relatively modest major bank exposure and added exposure to gold. We are also carrying more cash than we have historically to meet capital calls for industrial companies with too much debt.

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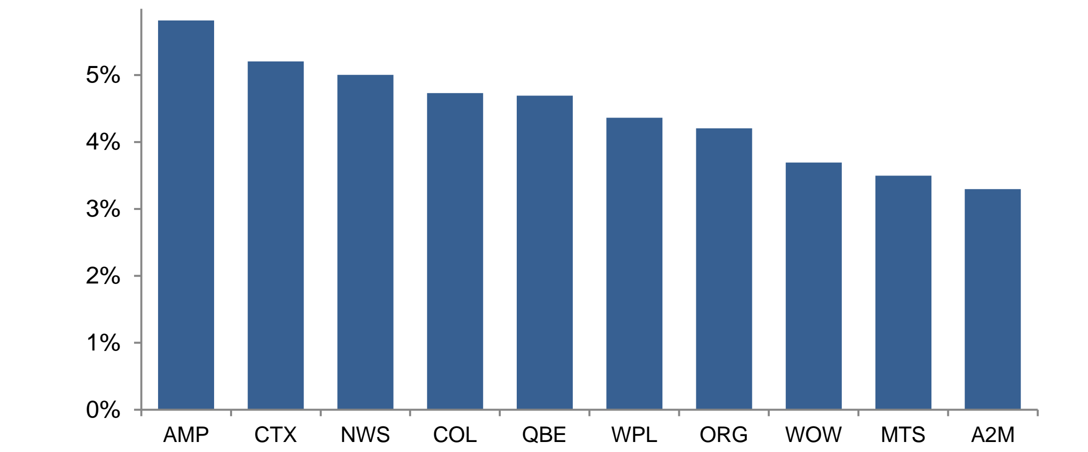
The portfolio comprises undervalued businesses based on sensible interest rate and risk margin assumptions…

Portfolio Aligned to Value Philosophy and Fundamental Research

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 6: 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). AMP has recently stated the $3b life sale transaction is on track to complete before 30 June, leaving just over $1b residual market capitalisation for approximately $200m-$300m in operating earnings excluding the financial advice business.

Caltex is an integrated oil refining and fuel supply and marketing company, operating in a strong and improved industry structure dominated by vertically integrated companies capable

of generating margins throughout their supply chain. Volumes are clearly impacted by COVID-19 related disruptions but the company is in a strong position to gain share with over seventy percent of the firm value (debt plus equity) at quarter end represented by hard assets, working capital and surplus franking credits. We also think the take-over offer has a reasonable chance of being reinstated, with the release of franking credits even if at a reduced headline price.

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** are attractively priced both in absolute terms and more so relative to other “defensive” sectors that are included in the “bond proxy” group. Both companies operate under an umbrella of a sound industry structure (Kaufland exit during the quarter is further evidence of this), provide long term inflation protection, have minimal debt and are generating margins below historic levels. While less relevant to our long-term investment case, the outlook for near-term earnings as an “essential service” is robust. **Metcash**, as the more marginal operator in the industry, is even more leveraged to near-term demand and a return to long-term inflation.

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, the quality of the portfolio has improved and underwriting conditions are the best in a decade.

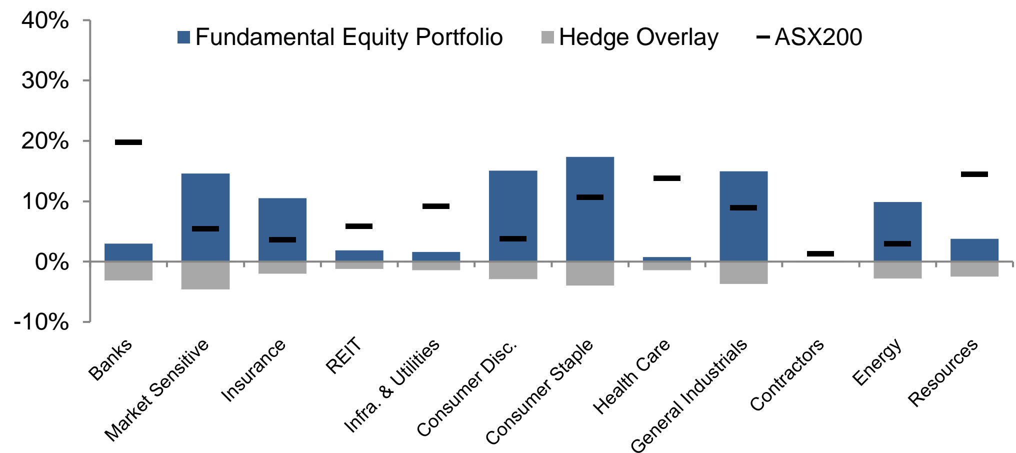
Origin Energy and **Woodside Petroleum** are both exposed to robust LNG portfolios being underappreciated by the market, and an oil price that is not reflecting the likely decline of non-cash generating unconventional US oil production, coupled with the underinvestment in conventional fields. They are both low cost operations with lower risk balance sheets (relative to peers) that make them more resilient to depressed oil prices while offering significant upside when demand recovers.

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. While they appear undervalued in a rapid economic recovery scenario, the upside in less leveraged industrials is similar without the tail risk that comes with a

protracted economic downturn. Their earnings relative to lending assets is below average, usually a positive sign for contrarian investors, but low interest rates and government interference could lead to a UK style scenario where banks, such as Lloyds Banking Group, with double digit advertised returns trade well below book value for extended periods.

There are many extraordinary long-term value opportunities at present. After raising capital to repay debt, **Southern Cross Media's** pre COVID-19 earnings represent a 25% return on capital at risk (current market capitalisation plus debt) and **Flight Centre's** equivalent return is 20%, which compensates investors for the lengthy period it might take for earnings to recover. **Sandfire**, a low cost copper miner with net cash and surplus franking equal to more than half its market cap, has a cash earnings yield in excess of 30% on a similar basis. The last example, and there are many more, is global fund manager, **Janus Henderson**, also offering a 30% return on capital at risk (60% of its market cap is accounted for by cash and investments), as well as having majority USD-based earnings and a highly variable cost base.

Figure 7: Portfolio exposures by sector (gross weights)



Source: Merlon

Figure 8: Portfolio Analytics[ii]

	Portfolio	ASX200
Number of Equity Positions	46	201
Active Share	78%	0%
Merlon Valuation Upside	75%	6%
EV / EBITDA	7.8x	13.0x
Price / Earnings Ratio	14.1x	16.9x
Price / Book Ratio	1.8x	3.8x
Trailing Free Cash Flow Yield	4.9%	4.4%
Distribution Yield (inc. franking)	6.6%	6.1%
Net Equity Exposure	64%	100%

Source: Merlon

The hedge overlay offers material downside protection

At quarter end, the hedge overlay was slightly higher than the targeted 30% reduction in market exposure. Given the sharp fall in the market the value of the put options held by the Fund increased above the exposure target, this will naturally rebalance as these positions are rolled on maturity.

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March Quarter Portfolio Activity

During the quarter, we reduced banks in favour of quality , undervalued industrials with leverage and cyclical concerns …

During the quarter we increased **Cash** from the typical one percent to over five percent to take advantage of deeply discounted capital raisings in quality industrials oversold on leverage and cyclical concerns. **Southern Cross Media, Ooh! Media** and **Flight Centre** are recent examples but, in the absence of a V-shaped recovery, we expect many more in the months ahead.

In line with our roadmap, we recognized the major banks, as the most leveraged companies on the ASX, were most at risk under a protracted period of below trend economic growth. Low rates impact banks revenues and government support could result in a "quid pro quo" with banks being forced to carry high levels of non-performing loans yielding non-commercial rates of interest. As a result, we exited our holdings in **ANZ Bank** and **National Australia Bank**, and reduced our investment in **Westpac**.

Ahead of the crisis we had switched our **Commonwealth Bank** position into **National Australia Bank** on relative valuation grounds after investing in CBA when it traded at a large discount during the 2017 anti-money laundering crisis.

A portion of the bank proceeds were used to raise cash as described above, but the majority was invested in companies oversold on leverage and cyclical concerns. We invested in our first property stock in some time, **Unibail-Rodamco-Westfield**, where leverage concerns led the European and US capital city malls operator to trade at just 20% of its book value. We estimate cap rates would need to expand by around 250bp or rents permanently reduce by around 65% to justify a valuation of this level. Given the quality of the properties in question, most commercial banks would likely be insolvent under this scenario.

We introduced a new investment in **Star Entertainment Group**, with market concerns about its temporary closure and debt levels leading it to trade at the book value of its property assets despite historical returns on these assets of around 18%.

We also added to existing investments in quality retailers facing temporary closure, such as **Nick Scali**, **Harvey Norman** and **Super Retail**. History has shown us that category leaders typically gain share from weaker competitors post crisis and even more so if they have hard property assets. In a similar vein, we added to fuel retailers and refiners, **Caltex** and **Viva Energy**, with a cyclical demand reduction mitigated by the former's property assets and the latter's cash balance after disposing of its property trust just prior to the market correction.

… balanced by increasing cash and buying undervalued defensives with strong balance sheets

We added to our existing fund manager investments, **Pendal** and **Janus Henderson**, with net cash balance sheets and variable cost structures mitigating the impact of falling markets and further outflows. We added to our investment in **AMP**, with the vast majority of its market cap now represented by the expected life insurance proceeds despite generating several hundred million dollars a year from its unlisted and listed fund managers, bank, New Zealand and platform and advice businesses.

We made small initial investments in **Medibank Private** and **NIB Holdings**, both offering attractive risk-adjusted upside on concerns relating to member affordability and claims inflation. While these concerns were appropriately discounted into the share prices, the prospect of favourable regulatory reform in the wake of the COVID-19 pandemic is greatly enhanced. We also re-invested in **Insurance Australia Group** which had underperformed on elevated claims in late 2019 but is now under-earning with a strong balance sheet and has a prospect of materially reduced claims this year.

We increased our investment in **Metcash**, which is even more leveraged to heightened demand for its food, liquor and hardware businesses than **Coles** and **Woolworths**, although we continue to hold all three notwitstanding taking profits during the period.

With regard to resources companies, we made a new investment in **New Hope Coal**, a low-cost thermal coal miner, with its double digit free cash flow yield more than compensating for the risk of lower coal prices. Unlike iron ore, coal prices were already depressed and declining industry profitability should lead to higher cost operators exiting the market.

We also added to existing oil positions and introduced new investments in coal and gold

With regard to oil, the trade war related optimism at the start of the year quickly gave way to the demand destruction caused by COVID-19 lockdowns, exacerbated by a breakdown in OPEC+ negotiations to curtail supply. We added to both our oil linked exposures, **Origin Energy** and **Woodside Petroleum** as their low-cost operations and lower risk balance sheets (relative to peers) make them more resilient to depressed oil prices while offering significant upside when demand recovers.

Finally, we invested in **Newcrest Mining**, a low cost, long reserve life gold miner, generating 10% cash yield on the value of its equity plus debt. The company had underperformed due to temporary production outages and a weaker gold price. Our original gold view was unconventional monetary policy would unwind, especially with the trade war resolving. However, COVID-19 has led to globally synchronized and even more extreme fiscal and monetary responses, undermining the value of official currencies. Gold initially underperformed as inflation expectations reduced on the demand shock, most notably in oil. However we expect gold to be a hedge against government over-stimulus and resultant blow-out in debt, with inflation risks further compounded by longer lasting supply-chain impacts of the pandemic.

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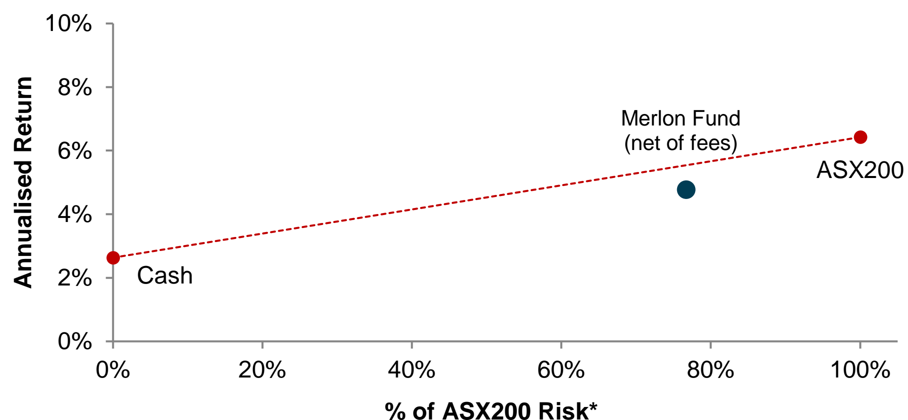
Performance[i] (%) (after fees, inc. franking)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)	10 Years (p.a.)
Fund Total Return	-18.6	-23.2	-19.9	-16.4	-3.3	1.0	3.6	4.8
70% ASX200 / 30% Bank Bills	-14.3	-15.9	-13.5	-8.4	1.4	2.8	5.3	5.5
ASX200	-20.4	-22.7	-19.6	-13.1	0.9	2.9	6.3	6.4
Average Daily Exposure	64%	66%	67%	67%	68%	69%	70%	70%
Gross Distribution Yield	0.7	1.6	4.4	6.2	6.8	7.2	7.4	8.6

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.
The source of fund returns and benchmark returns is Fidante Partners Limited, 31 March 2020.

Figure 9: Rolling Ten Year Risk vs. Return (%p.a.)[ii]



Source: Merlon

March Quarter Market & Portfolio Review

The ASX200 had its worst quarter since 1987

After rallying 8% to the 20th of February, the market declined 36% to Monday 23rd February, then recovered 12% to finish the quarter down 23%, the worst quarter since 1987. Unprecedented fiscal and monetary stimulus to offset the COVID-19 induced demand and supply shocks coincided with the currency falling 9c to 61c and US bond yields dropped 120bp to 70bp. Oil plummeted USD42 to USD23 on both the anticipated demand shock and break-down of OPEC+. Gold rose modestly to USD1,609. Iron Ore was broadly flat, ending the quarter at USD 84.

with the Fund underperforming by 0.5%…

Healthcare, Consumer Staples and Utilities were the best performing sectors. Energy, Property, Non-bank financials, Media and Consumer Discretionary performed worst.

The Fund fell in line with the market during the quarter as the share portfolio underperformed. As it is designed to do, the hedge overlay insulated the Fund from the full extent of the falls in the underlying share portfolio, contributing 8.3% to the Fund's return.

…non-benchmark and value have been headwinds initially …

The underlying share portfolio underperformed the market by 8.6%. As is often witnessed in the initial phase of a market downturn, the **non-benchmark** nature of the portfolio was a

headwind, with the average company underperforming the cap weighted index by 5% in the quarter.

This is most evident in the performance of CSL, which detracted 3% from relative returns in the past 3 months alone as its index weight increased from 7% to 10%. 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, and is often the case, the non-benchmark approach adds value in a recovery or if the downturn extends.

… but the fund remains true to label and is well positioned going forward

A **value and contrarian style** can also be a headwind in the early stages of a downturn through exposure to more cyclical sectors, such as energy and consumer, as well as exposure to some financial leverage. As we documented in our roadmap, we are focused on the risk of permanent loss and mitigate this by taking a long-term view, focusing on owning undervalued assets and fully deducting debt in developing our investment case. The portfolio is clearly underweight leverage through its small weighting in banks, infrastructure and property stocks.

The top performing investments in the quarter were the supermarket and liquor operators, **Coles**, **Woolworths** and **Metcash**, benefitting from strong balance sheets and upside to near-term earnings with out of home dining decimated by the lockdown and materially lower promotions required to attract customers. Similarly, **A2 Milk** performed well with a net cash balance sheet, revitalised management and an uplift in near-term demand. At a sector level, not owning leveraged **Real Estate Investment Trusts**, **Developers and Contractors** and **Macquarie Bank** benefitted relative performance in the latter stages of the quarter as the market came to the realisation this crisis will expose over-leveraged companies as opposed to merely cyclical ones.

The largest detractor was being **non-benchmark**, or having a mid-cap as opposed to large-cap bias to the portfolio as described above. Not owning **CSL** and other healthcare stocks was the biggest detractor to relative performance. With regard to stocks held, the largest detractors at a sector level were exposure to energy, domestic consumer and industrial companies, and fund manager and platform operators. **Woodside** and **Origin Energy** are low cost with lower risk balance sheets but still detracted from performance with oil collapsing more than 60%. Category leading retailers such as **Super Retail**, **Harvey Norman** and **Nick Scali** detracted on lockdown concerns. **Southern Cross Media** detracted, with cyclical advertising revenue and an over-stretched balance sheet, although after quarter end, the company pleasingly managed to raise capital and outline a strategy for the more defensive regional radio franchise to recover during and after the crisis. Fund managers and platform operators such as **IOOF** detracted, based on revenue linkages to market declines, despite being more diversified than perceived, with strong balance sheets, variable costs, and most importantly, an ability to earn revenue whatever shape the recovery takes.

Over the nine-month financial year to date period, the Fund has performed inline with the market. The hedge overlay has contributed strongly, adding 7.7%, however the share portfolio underperformed the market's 20% decline by 7.4%.

Similar themes contributed to performance as the most recent quarter, such as a calculated and deliberate positioning away from inflated sub-components of the index, most notably "bond proxies", technology and iron ore. As an example, **CSL** alone detracting almost 5% from relative performance. At a stock specific level, the detractors were broadly the same as the past quarter, being **Southern Cross Media**, **Boral** and **Origin Energy**. On the other side of the ledger, the best performing investments relative to the market over this period have been **Coles**, **A2 Milk**, **Metcash**, **Caltex** and not owning **Scentre Group**.

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 16.

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Additional Performance Detail: Sources of Return

FY Performance[i] (%) (inc. franking)	20TD	2019	2018	2017	2016	2015	2014	2013	2012	10 Years (p.a.)
Underlying Share Portfolio	-27.1	8.4	7.4	23.5	7.0	9.5	16.3	36.0	-3.4	6.3
Hedge Overlay	7.7	-0.9	-2.3	-5.6	-0.9	-1.7	-3.5	-9.3	2.6	-0.5
Fund Return (before fees)	-19.3	7.5	5.1	17.9	6.1	7.8	12.8	26.7	-0.8	5.8
Fund Return (after fees)	-19.9	6.5	4.1	16.8	5.1	6.8	11.8	25.6	-1.8	4.8

FY Performance[i] (%) (before fees, inc. franking)	20TD	2019	2018	2017	2016	2015	2014	2013	2012	10 Years (p.a.)
Underlying Share Portfolio	-27.1	8.4	7.4	23.5	7.0	9.5	16.3	36.0	-3.4	6.3
ASX200	-19.6	13.2	14.5	15.5	2.2	7.2	18.9	24.3	-5.1	6.4
Excess Return	-7.4	-4.8	-7.1	8.0	4.8	2.3	-2.7	11.7	1.7	-0.1

FY Performance[i] (%) (after fees)	20TD	2019	2018	2017	2016	2015	2014	2013	2012	10 Years (p.a.)
Income	3.3	5.8	5.5	6.2	5.9	5.6	5.8	7.8	7.6	6.6
Franking	1.2	2.2	1.5	1.6	2.1	1.9	1.7	2.3	2.5	2.1
Growth	-24.3	-1.4	-2.8	9.0	-2.9	-0.7	4.3	15.5	-11.9	-3.9
Fund Return (after fees)	-19.9	6.5	5.1	16.8	5.1	6.8	11.8	25.6	-1.7	4.8

FY Performance[i] (%) (after fees, inc. franking)	20TD	2019	2018	2017	2016	2015	2014	2013	2012	10 Years (p.a.)
Fund Return (before fees)	-19.3	7.5	5.1	17.9	6.1	7.8	12.8	26.7	-0.8	5.8
70% ASX200/30% Bank Bills	-13.5	9.9	10.6	11.3	2.2	6.0	14.0	17.8	-2.1	5.5
Excess Return (before fees)	-5.9	-2.4	-4.4	6.6	3.9	1.8	-1.2	8.9	1.3	0.3
Excess Return (after fees)	-6.4	-3.4	-5.4	5.5	2.9	0.8	-2.2	7.7	0.4	-0.8

Monthly Distribution Detail: Cents per Unit

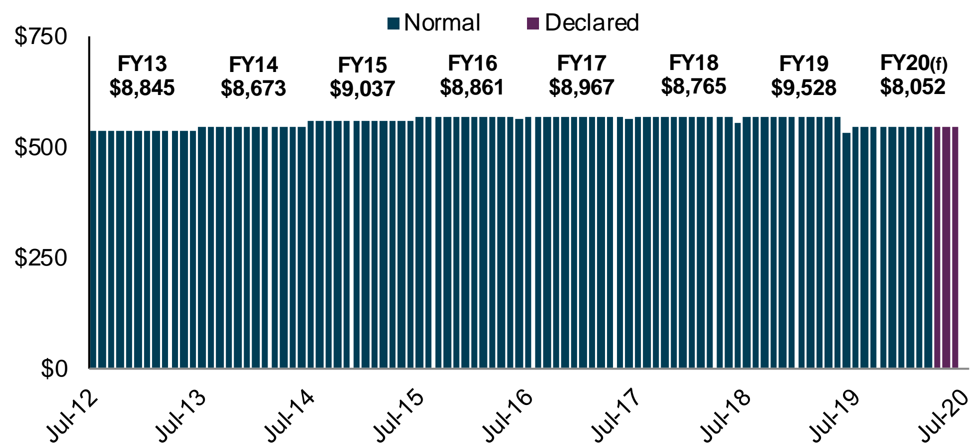
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Total	Franking
FY2013	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.29	**6.79**	2.26
FY2014	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.52	**6.13**	1.98
FY2015	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	**6.24**	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***	*1.40*

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 60-70% range

Figure 10: Monthly Income from $100,000 invested in July 2012[iii]



Source: Merlon, excludes bonus income in FY13

MERLON CAPITAL PARTNERS

Links to Previous Research

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Why Telstra could be worth less than $2

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Iron Ore is Well Above Sustainable Levels

Boral's High Priced Acquisition of Headwaters

MERLON CAPITAL PARTNERS

Fund Details^

Fund size	$ 417m	Merlon FUM	$ 816m
APIR Code	HBC0011AU	Distribution Frequency	Monthly
ASX Code	MLO02	Minimum Investment	$ 10,000
Inception Date	30 September 2005	Buy / Sell Spread	+/- 0.20%

^Source: Fidante Partners Limited, 31 March 2020.

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.

MERLON CAPITAL PARTNERS

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 0.3%, Qtr 0.5%, FYTD 1.2%, Year 1.8%, 3 Years 1.7% p.a., 5 Years 1.7% p.a., 7 Years 1.8% p.a., 10 Years 2.1% p.a.
ASX200 Franking^: Month 0.2%, Qtr 0.4%, FYTD 1.1%, Year 1.4%, 3 Years 1.5% p.a., 5 Years 1.5% p.a., 7 Years 1.5% p.a.,10 Years 1.5% p.a.
^ Source: Fidante Partners Limited, 31 March 2020.

[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), $2,752 (FY19) and $1,927 (FY20 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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