



Merlon Income Strategy

Merlon Australian Share Income Fund

Quarterly Report

September 2020

Contents

Oil – Pricing in a more realistic recovery	3
Market Outlook	13
Portfolio Positioning	15
September Quarter Portfolio Activity	18
September Quarter Market & Portfolio Review	19

Analyst:
Ben Goodwin



Oil – Pricing in More Realistic Recovery

Oil remains in a holding pattern between USD40-45/bbl as the 7.7mbpd OPEC+ supply reductions balance demand, which is currently ~10% below pre-COVID levels. In comparison, oil exposed equities are currently 40-50% lower than pre-COVID levels. Should a vaccine be developed, an outcome we consider likely, then we would expect to see a normalisation of demand, implying equities return to pre-COVID levels. Should the current cuts to capital expenditure result in a decline in supply, then we would expect to see prices rise above pre-COVID levels.

We explore the outlook for oil and related equities in this paper, with the key points being:

1. The recovery in **demand** has continued cautiously, despite second waves, with a normalisation of demand considered likely in the event of a successful vaccine.
2. Prices have been supported in the current demand environment by **OPEC+ discipline**
3. The longer oil remains below USD50/bbl, the larger the **supply impact** from the US is likely to be, given rig counts at historic lows and a high decline rates.
4. Any reduction in US supply is likely to be exacerbated following years of **underinvestment** outside the US, as the US growth disincentivised investment elsewhere.
5. **Oil-exposed equities** are trading at levels roughly half of pre-COVID levels – we believe it is increasingly likely they will ultimately trade at levels above these levels for the above reasons.

Figure 1: Oil and equity indices



Data source: Apple Mobility Trends / Flight Radar 24. Calculations: Merlon Capital. October 2020.

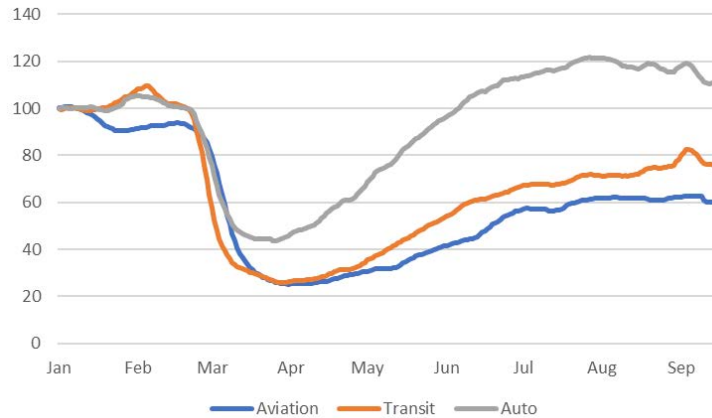
As written by Fama and French in 2015, investment at the firm level is inversely correlated with future returns. We believe this is a function of low returns driving capital out of a company / industry, driving low investment and in turn reduced supply, thereby increasing future returns. We believe the oil market, and associated equities, is no different.

Demand recovery is underway, albeit slower than expected

1. Demand recovery – auto lags, diesel steady, jet lags

Following the trough in demand experienced in April, roughly 25% below normal levels, we have seen a recovery back to less than 10% below normal. While social-distancing has seen a marked reduction in public transport usage, this has been offset by personal auto usage, enabling ‘socially-distanced transport’. This leaves aviation as the major source of oil demand decline still evident. A recovery in this sector will be largely vaccine dependent.

Figure 2: Activity indices CYTD

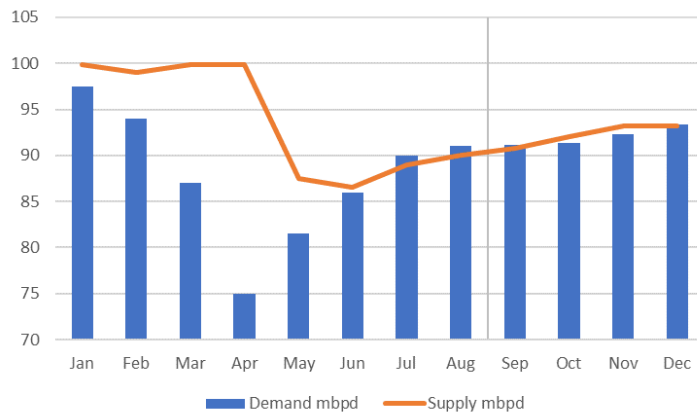


Data source: Apple Mobility Trends / Flight Radar 24. Calculations: Merlon Capital. October 2020.

2. Supply discipline – OPEC+ steadies the market

While demand troughed in April, supply took an additional month to be fully implemented, driven largely by the efforts of the OPEC+ cartel. The increase in supply that has followed this trough has come predominantly from the OPEC+ agreement loosening, which saw an additional 2mbpd added to supply. These efforts have seen the supply / demand balance largely restored, albeit not at a level sufficient to drain the ~1.3 billion barrels of oil stockpiles built during the crisis.

Figure 3: Oil Production Evolution – 2016 Crisis Response to COVID-19



Source: Rystad Energy. Calculations: Merlon Capital, October 2020.

High inventories may cap prices in the short-term

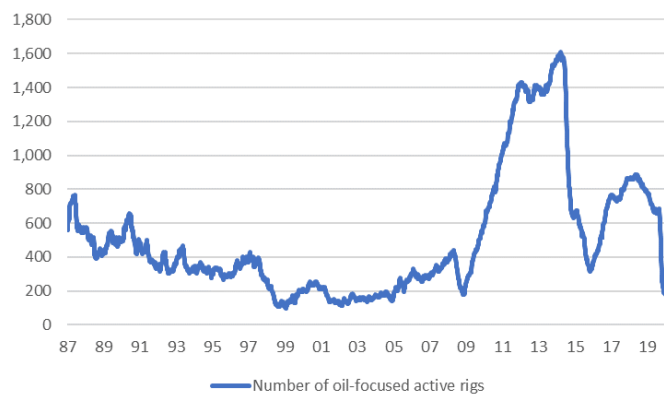
US Shale decline rates could soon be exposed

Given the market has been stabilised, notwithstanding any outsized ‘second-wave’ effects, the focus is to work off inventories, which stand at more than three-times 2014-16 levels. We expect the OPEC+ production agreement will be extended, albeit not at a level that would see prices rally quickly enough to re-incentivise US onshore production (see below).

3. Unconventional: shale’s excessive decline rates may finally be revealed

The market share of US oil and associated liquids production has risen from 8% to 17%, driven by aggressive horizontal drilling and fracking across onshore fields. Yet this activity, while delivering stellar growth in production, has always lost cash as an industry – a function of the high decline rates in the sector. To date, these decline rates have been hidden behind growth in drilling activity, combined with concentration on higher grade deposits. Yet at current prices, there is little incentive to drill, with a survey by the Dallas Federal Reserve showing 1% of producers looking to increase drilling activities from current low levels at today’s prices, and only 10% should prices reach USD50/bbl. This price-disincentive has seen the rig count plummet. Perhaps more importantly, while the intention to drill may grow on higher prices, access to capital may be limited, with the negative oil prices seen in early 2020 still fresh in the minds of financiers.

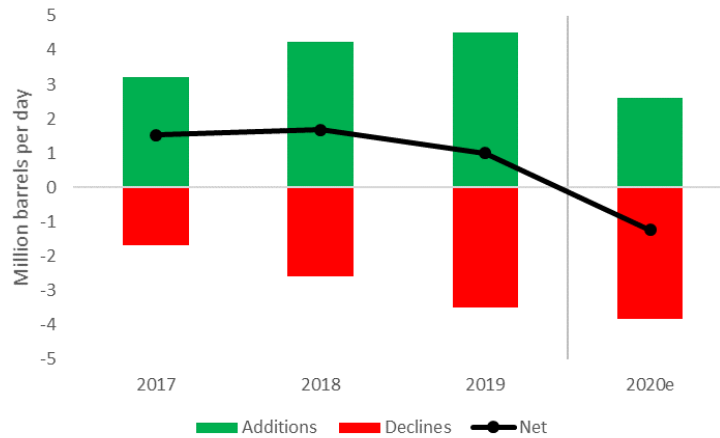
Figure 4: US shale patch – decline rates to be exposed by lack of activity



Source: Baker Hughes. Calculations: Merlon Capital, October 2020.

Yet, the US needs significantly more activity to at least offset declines (ie to maintain production). Rystad Energy estimates the need for an additional 100+ rigs just to avert declines. While small in the context of prior peaks in activity, it represents a greater than 50% increase from current levels, where current pricing is only incentivising 1% of producers to invest.

Figure 5: US shale patch – decline rates to be exposed by lack of activity



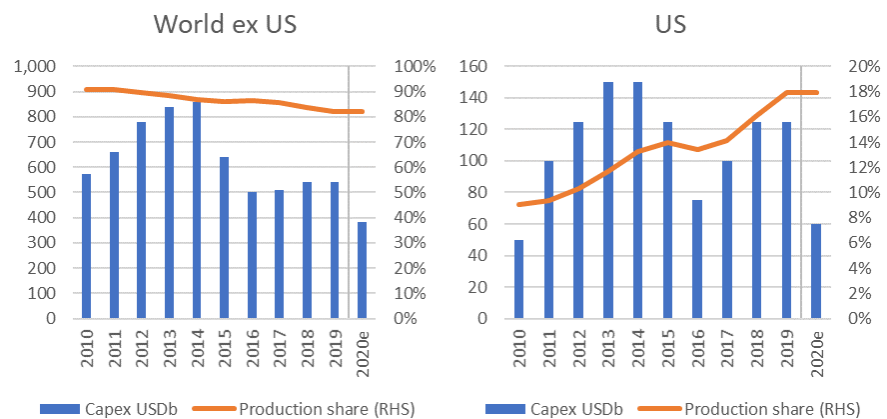
Source: Rystad Energy. Calculations: Merlon Capital, October 2020.

4. Conventional: from underinvestment, to disinvestment and energy pivots

Investment in conventional oil supply, which still accounts more than 80% of total supply, has suffered from a period of underinvestment. Capital expenditure from 2015 to 2019 was roughly 25% below that of the prior five-year period. With 2020 investment likely to be significantly below these already-low levels, the effects of this underinvestment is increasingly likely to worsen. Combined with subdued US volumes, this underinvestment could further limit any supply response to higher prices, with the potential for sharply higher prices as demand recovers.

Prices could overshoot on the upside when demand recovers

Figure 6: Conventional oil – crowded out



Source: Rystad Energy. Calculations: Merlon Capital, October 2020.

5. Equities: Upside from demand recovery enhanced by supply constraints

Merlon process: At Merlon, our process is aimed at ensuring we minimise our exposure behavioural biases and exploit misperceptions about risk and future growth prospects.

The first step in our process is determining sustainable free cash-flow. Commodity exposed stocks generally fare poorly in terms of undifferentiated product, high capital intensity and pro-cyclical capital allocation. However, opportunities can arise when commodity prices are low, and industry investment is also low, as supply ultimately tightens and prices normalise.

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 other investors have become too concerned (or complacent) about risks and growth.

We then set conviction, which recognises that to be a good investment, we need evidence 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 (bear case) relative to the upside scenario (bull case).

Merlon positioning: We hold upstream positions in **Woodside Petroleum**, **Origin Energy** and **Oil Search**, established based on an expected tightening of global oil markets over the medium term. The current price environment is pressuring the conventional and unconventional oil and gas businesses, leading to lower investment in future supply. We expect this, in conjunction with a vaccine-led normalisation of demand, to lead to higher prices for oil and gas.

Even if we are wrong and oil prices do not recover to the extent we expect, we see the downside in these names as limited given their low cost of production and improved balance sheets. As such, the risk / reward is skewed to the upside. We also hold downstream positions in **Ampol** and **Viva Energy**, based on a favourable industry structure, and upside to refining margins given historic cyclicity of this industry.

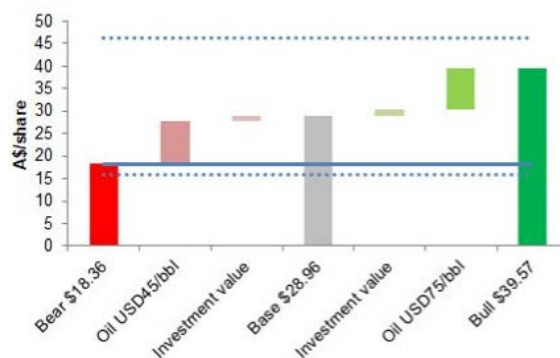
Commodity stocks are a good illustration of Merlon's process ...

Oil is pricing in a more subdued recovery, offering downside protection relative to the broader market



Company overview: Woodside Petroleum (WPL) is the leading Australian LNG producer, with significant Western Australia-based conventional oil and gas operations. The company has generated strong cash-flows since the commissioning of Pluto in 2012. The company has significant growth potential, as evidenced by its undeveloped reserve position, via key projects such as Browse and Scarborough, in anticipation of continued growth in demand for cleaner gas fuels, as well as its conventional oil Sangomar field in Senegal.

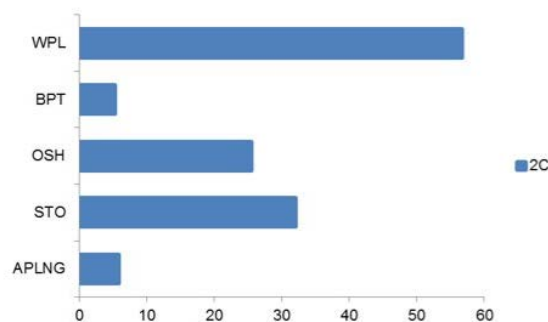
Merlon Valuation Range:



Valuation & market reasoning: We value Woodside at AUD29.96 per share, within a range of AUD18-40/share, based on its sustainable free cash flow under a range of scenarios. The company has underperformed due to concerns over its declining production profile, coupled with the demand interruption driven by COVID-19. At USD42 spot oil, WPL is cash-flow

positive, yielding 4%, rising to 11% should oil demand recover, and 18% if supply declines. Our bull case reflects under-investment outside of the US and ironically becomes more likely the longer prices stay low. On this basis the risk/reward skew is very favourable even if oil prices drift lower in the short-term.

Growth optionality



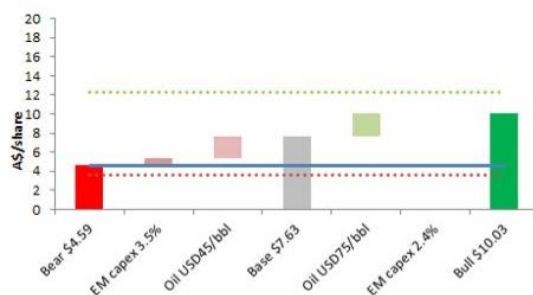
Merlon view: We believe the market is underappreciating the long dated value of its growth optionality in light of recent acceleration in China's pollution-driven demand for gas fired generation, coupled with an expected long term crude oil price, which forms the basis of its LNG contract pricing, being supported at USD60-70/bbl. We see upside to this price from a phase

of underinvestment in conventional oil and gas globally, and more recently across US unconventional oil and gas activity.



Company and quality overview: Origin Energy (ORG) is the leading Australian east coast energy retailer, with four million customers, supported by upstream coal and gas generation, as well as owned and contracted renewables generation. The company has been operating its LNG facility on Curtis Island (QLD) since 2016, having received more than \$2.3b in distributions, and which is expected to contribute further significant cash flows as oil prices normalise.

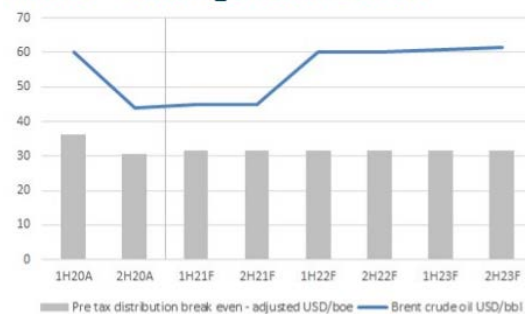
Merlon Valuation Range:



Valuation & market reasoning: We value ORG at \$7.63 per share, within a range of \$4.50-\$10 per share, based on its sustainable free cash flow under a range of sensible scenarios. Currently trading at the bottom of this range, the market is concerned about low near-term oil prices due to COVID demand impacts and long-term headwinds for oil demand.

The market is also concerned about low electricity prices, a function of renewables growth as well as the pandemic, as well as some loss of market share as the company sought to maintain margins .

APLNG – a cash generative asset



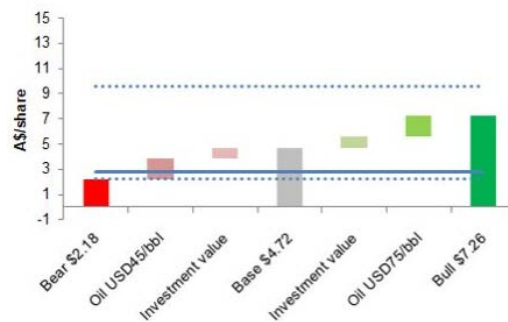
Merlon view: The market is attributing minimal value to APLNG despite the significant cash distributions it provides Origin under a normal oil price environment, and despite the cash generative nature of its dominant east coast energy markets business. We believe there is upside risks to our central case, as the longer oil prices

remain at current levels, the longer US oil and gas rigs will remain at historic lows, and hence, the greater the impact on future oil supply. Similarly, current electricity prices, coupled with energy policy uncertainty, threaten private sector investment in generation, and hence risk a tighter future market.



Company and quality overview: Oil Search (OSH), in partnership with ExxonMobil, is the leading Papua New Guinea LNG producer. The company has generated nearly USD2b in free cash-flow since the commissioning of its large-scale conventional gas and condensate PNG LNG project in 2015. The company has large growth opportunities both within PNG and Alaska, in order to take advantage of a shift toward less carbon-intensive sources of electricity generation.

Merlon Valuation Range:



Valuation & market reasoning: We value OSH at AUD4.72/share, within a range of AUD2.18-7.26 per share, based on its sustainable free cash flow under a range of scenarios. The stock is trading towards the bottom end of this range, with the market concerned about the impact of COVID on near-term oil prices (via weak demand) and political uncertainty in PNG. OSH also has

reasonably elevated debt, despite raising capital earlier in the year.

PNG LNG – a low cost asset



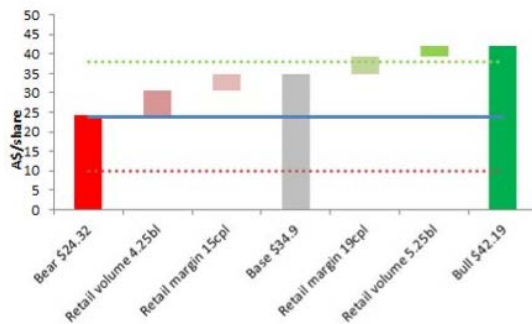
Merlon view: Lower oil prices in the short-term typically lead to deferred investment in production capacity, resulting in a decline in supply, and price normalisation. We see upside to this price from a phase of underinvestment in conventional oil and gas globally, and more recently across US unconventional oil and gas activity. At current

oil prices, OSH continues to generate positive cash-flows, as at USD21/boe, OSH costs are highly competitive.



Company and quality overview: Ampol (ALD) is the leading Australian supplier of petrol and diesel product. The company has a sizeable commercial business, accounting for 50% of total volumes, combined with a one-third retail market share position, via 700 company owned and operated sites, and supply agreements to non-owned Ampol-branded sites. The industry structure is highly favourable with the top three operators supplying or retailing more than 80% of total volumes. Over time, the company has reduced its exposure to the more capital-intensive refining segment, focusing on its marketing division, with an integrated cash return on invested capital above 10%.

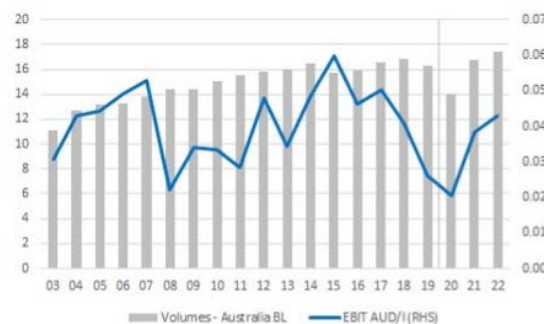
Merlon valuation range:



Valuation & market reasoning: We value Ampol at between \$25 and \$42 per share (\$35 central case), with the stock currently trading towards the bottom of this range as the market is concerned about the impact of COVID on retail volumes, longer term declining fuel volumes (including the effect of electric vehicles), the sustainability of premium fuel margins, the ability to extract

value from convenience sites, and weak refining margins.

Margin cyclicity



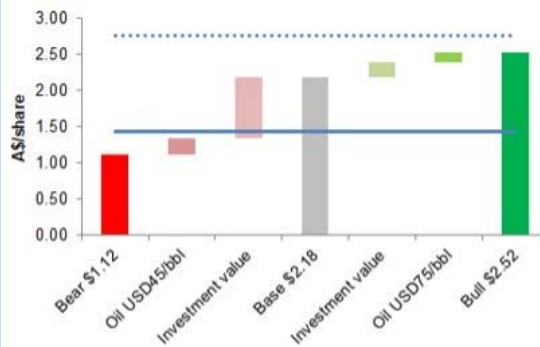
Merlon view: ALD is trading at nearly 50% below our central case. We believe historically cyclical refining margins, currently 40% below mid-cycle, will revert to normal levels. More importantly, the industry structure has enabled retail fuel margins more than offset COVID driven volume declines (1H20 retail earnings before interest and tax was higher than

pre-COVID levels). Further, we believe the market is not factoring in the growth in premium fuels consumption, the recently announced Woolworth's Metro-branded and supplied convenience strategy, or the company's superior infrastructure position and regional sourcing scale.



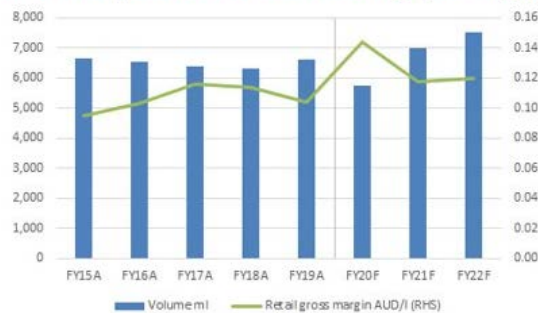
Company and quality overview: Viva Energy (VEA) is a large-scale Australian supplier of petrol and diesel product. The company has an attractive retail model, with Coles Express operating the shop, and Viva retaining control over retail pricing and margins. Viva also has a large commercial business, accounting for 45% of total volumes, combined with a 20% retail market share position. The industry structure is highly favourable with the top three operators supplying or retailing more than 80% of total volumes.

Merlon valuation range:



Valuation & market reasoning: We value Viva at AUD2.21/share, within a range of AUD1.12 per share to AUD2.52 per share, based on its sustainable free cash flow under a range of scenarios. The stock is currently trading towards the bottom of this range as the market is concerned about the impact of COVID on retail volumes, longer term declining fuel volumes (including the effect of electric vehicles), and the sustainability of premium fuel margins.

Industry structure enabling pricing power



Merlon view: VEA is trading roughly 50% below our central case. We believe historically cyclical refining margins, currently 40% below mid-cycle, will revert to normal levels. More importantly, the industry structure has enabled retail fuel margins to more than offset COVID driven volume declines (1H20 retail EBIT was higher than pre-COVID levels). Further, we believe the market is not factoring in the value of its retail model, nor the latent value of its physical asset base (including the property value of its Gore Bay terminal in harbour-front Sydney, should this be converted).

Neil Margolis



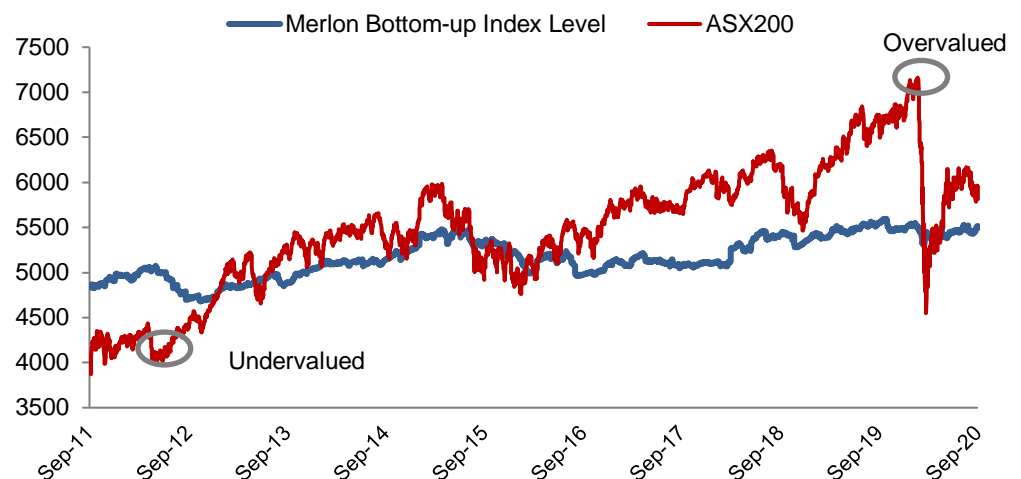
Market approximately 6% undervalued using consistent bottom-up approach...

The global economy is unlikely to operate anywhere near pre-crisis levels for some time...

Market Outlook and Portfolio Positioning

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 7% overvalued after tracking sideways during the quarter.

Figure 7: 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 always maintain a long-term view. In that respect, as we indicated in our last quarterly update, we remain optimistic that at some point there will be a vaccine, herd immunity will develop, and ordinary life will bounce back. The market has rallied hard off the March lows at least in-part reflecting this situation.

But we continue to think that a distributed vaccine and/or herd immunity is at least 12 months away and in the interim it is difficult to envisage the global economy will operate at anywhere near pre-crisis levels. The politics of the crisis are emerging as a potentially more powerful force than the virus itself.

The risks directly associated with the Covid-19 crisis are being manifested by secondary impacts such as political tensions with China, the US electoral cycle and the potential for social unrest. All these issues were bubbling below the surface prior to the crisis but have become more pertinent in recent months. None of these are good for global economic growth and all point to further fiscal and monetary stimulus as well as a more volatile and more extended recovery path.

We continue to stress test all our investments against this backdrop. Some companies will face severe balance sheet strain for extended periods of time (for example the travel related businesses, cafes & restaurants and banks) while others face the prospect of permanent changes in the way they operate (for example real estate owners).

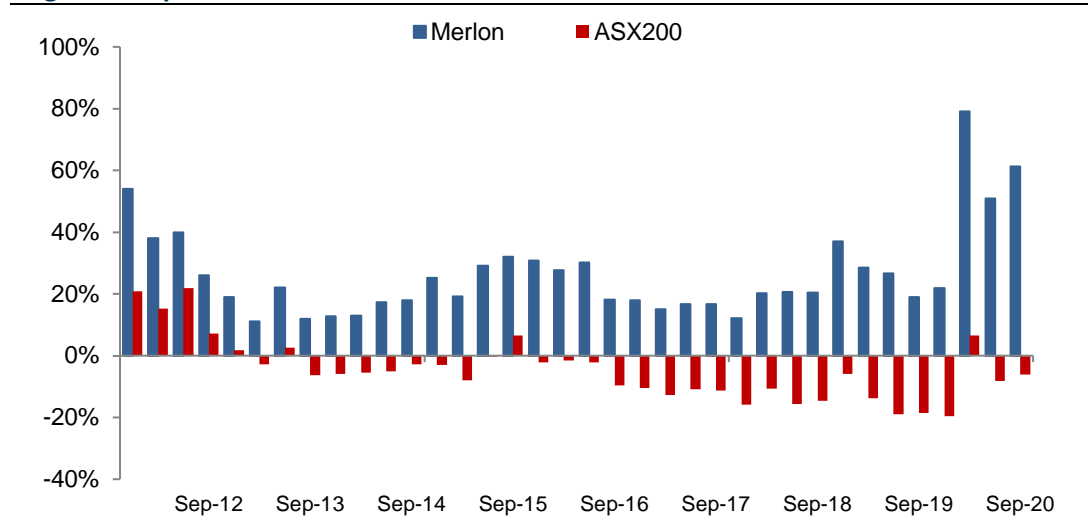
Our view is that the risk of permanent loss through the current crisis is mitigated by owning undervalued assets. This is not to say that undervalued assets cannot fall more than expensive assets over short periods of time. Rather, our emphasis is stress testing our investments to ensure we deliver good returns relative to the risk of permanent loss.

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

The Merlon portfolio continues to offer truly exceptional expected returns...

The short-term outlook is difficult to predict...

Figure 8: Expected return based on Merlon valuations



Source: Merlon

Our expectation of a volatile and more extended recovery path than initially envisaged, combined with the rapid pace of the market recovery has led us to reposition the portfolio towards affected industries and cyclical businesses a little more slowly than might have otherwise been the case.

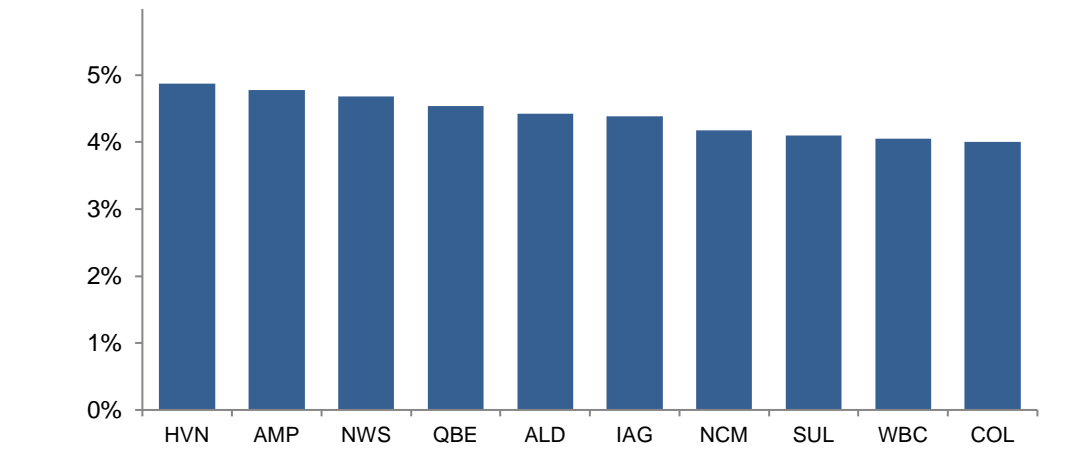
We expect the environment over the next year or so will continue to present wonderful investment opportunities for investors with long-term horizons, who are prepared to look through short term noise and who are comfortable having unpopular views.

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 9: 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.

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. However, we added to **Westpac** during the quarter and it now appears in our top 10 holdings. The bank offers material upside in a vaccine-led recovery with less downside than the other banks in a deeper recession given its high-returning retail business mix (similar to CBA) and very low market expectations on account of money laundering breaches and management turnover.

Harvey Norman has and continues to benefit from government stimulus and a shift from discretionary travel spend to furniture, electronics and white goods. It is unlikely the business will sustain the type of sales growth experienced in recent times but against this market expectations remain very low.

Post completion of the life transaction and other announced transactions, **AMP** has net tangible assets (mainly cash) of \$3.5b against a market cap of \$4.8b. For the \$1.3b capital at risk, investors own a growing fund manager, AMP Capital, with \$190b FUM (including \$60b in “real assets”), a high returning bank (\$20b in mortgages and \$17b deposits), a NZ wealth business (\$40m earnings), a \$120b platform administration business and a loss-making advisor servicing business net of corporate costs that might break-even if cost-out targets are achieved.

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 minimal value to any of the affected businesses.

QBE Insurance Group has seen a significant retracement of unrealised investment losses incurred during the early part of the Covid-19 Crisis leaving the business extraordinarily well capitalised coming into an environment of historically strong premium inflation in its core markets.

Ampol (formerly 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 downside risk mitigated by hard property assets. 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.

IAG is expected to recover margins following a difficult FY20, supported by a market leadership position in a good industry structure anticipated to drive growth in insurance premiums. While IAG’s underlying business is strong, FY20 earnings were impacted by the effect of COVID-19 on investment earnings across both equity and credit markets.

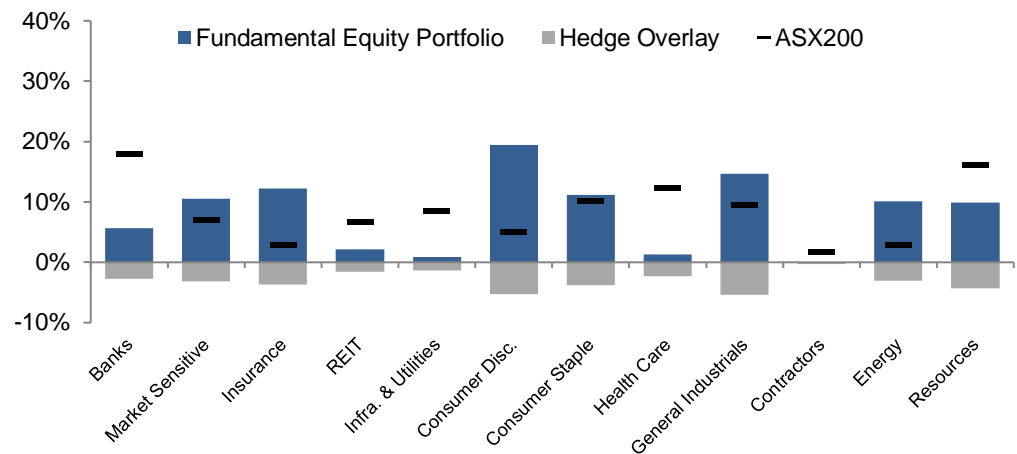
Newcrest Mining now features as a significant position in our portfolio. Newcrest is one of the world’s largest gold mining companies. Against the backdrop of a more extended volatile and extended recovery period coupled with further monetary and fiscal stimulus we believe the risk bias in the gold price is firmly to the upside. Newcrest continues to generate strong cash flow in the interim.

Super Retail is Australia’s leading auto, sporting and leisure goods retailer. The pandemic has provided an unexpected tailwind to all three segments but underlying market positions

are strong in all segments with the online business (including click and collect) well placed to compete with pure play online competitors.

Coles remains attractively priced relative to other “defensive” sectors that are included in the “bond proxy” group. Coles and Woolworths operate under an umbrella of a sound industry structure (Kaufland exit this year is further evidence of this), provide long term inflation protection, have minimal debt and are generating margins below historic levels.

Figure 10: Portfolio exposures by sector (gross weights)



Source: Merlon

Figure 11: Portfolio Analyticsⁱⁱ

	Portfolio	ASX200
Number of Equity Positions	36	200
Active Share	85%	0%
Merlon Valuation Upside	61%	-6%
EV / EBITDA	8.2x	14.9x
Price / Earnings Ratio	18.3x	20.4x
Price / Book Ratio	2.0x	4.7x
Trailing Free Cash Flow Yield	7.3%	4.4%
Distribution Yield (inc. franking)	5.5%	4.4%
Net Equity Exposure	63%	100%

Source: Merlon

The hedge overlay offers material downside protection

At quarter end, the hedge overlay was above the targeted 30% reduction in market exposure, and will provide material protection if markets retrace towards the recent lows.

There was minimal activity during the quarter.

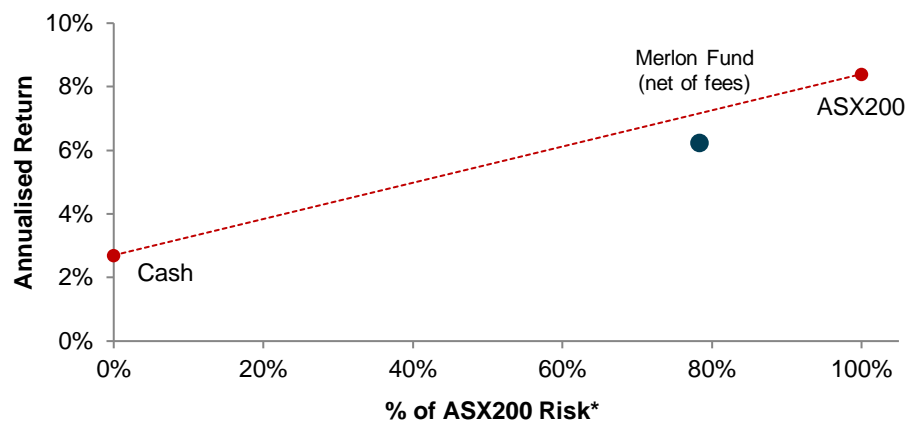
September Quarter Portfolio Activity

Activity was light during the quarter with no new material positions. We added to the existing position in **IAG**, offering more upside without the banking downside risk of **Suncorp**, which we exited. We added to existing holdings in **Westpac**, **Alumina** and **Star Entertainment Group**, funded by reducing holdings in **Bapcor**, **Harvey Norman** and **Woolworths**, which outperformed. We switched our holding from **Pendal** into **IOOF** which now has a market capitalisation of \$2.1b compared to \$1.6b the day before the \$1.4b MLC acquisition was announced. We agree integrating MLC will be very challenging but advertised synergies of \$150m offers plenty of headroom to compensate for the risk in our view.

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	-4.7	-3.2	-3.2	-12.5	0.3	5.2	4.6	6.2
70% ASX200 / 30% Bank Bills	-2.5	0.0	0.0	-5.5	5.1	6.9	6.0	6.9
ASX200	-3.5	-0.1	-0.1	-9.2	6.2	8.7	7.4	8.4
Average Daily Exposure	62%	64%	64%	66%	68%	68%	69%	69%
Gross Distribution Yield	0.7	1.6	1.6	5.9	7.0	7.3	7.3	8.4

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, 30 September 2020.

Figure 12: Rolling Ten Year Risk vs. Return (%p.a.)ⁱⁱ



Source: Merlon

September Quarter Market & Portfolio Review

The ASX200 index ended flat during a volatile quarter and behind the majority of other global share markets, which rallied on growing optimism of a vaccine and some better than expected economic readings. The Australian market lagged on account of a lower weighting of technology stocks, and higher weightings towards energy and financials. Continued monetary easing globally – in response to COVID - saw gold rise from USD1,770/oz to USD1,883/oz, albeit down from its intra-period highs above USD2,000/oz, as US treasury yields rose from 66 to 69 basis points – a small rise, but seen as a potential yield base. The impact of COVID from a demand perspective saw oil largely flat over the quarter, perhaps most importantly from the equity market's short-term focus, as it represented a plateau following its 57% rally in the prior quarter. Iron ore continued to rally, as COVID-driven Brazilian supply weakness combined with a manufacturing-driven China recovery rising to finish the quarter just below USD120/t. Australian house prices edged only 2% lower while the currency rallied 4%.

Similar to the June quarter, the best performing equity sectors over the quarter were Technology and Consumer Discretionary, while Real Estate also outperformed.

The ASX200 was flat although banks, insurers and energy stocks had a torrid time

... with the Fund underperforming ...

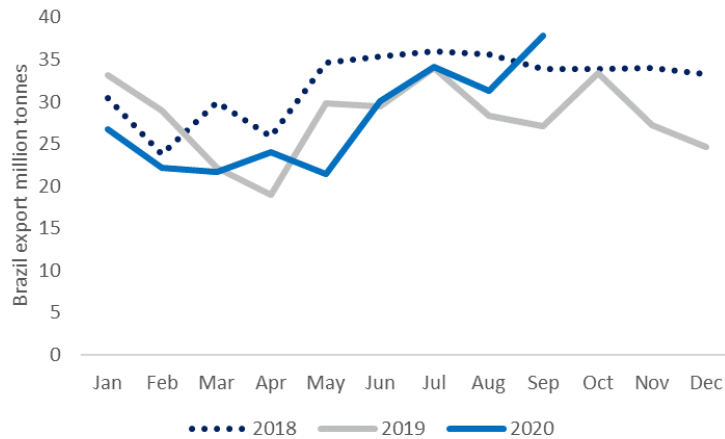
Conversely, Energy reversed some of its June gains, while Utilities and Financials also declined. For some time, lower rates have disproportionately benefitted the multiples of growth stocks.

The Fund underperformed during the quarter with the share portfolio declining. The hedge overlay protected the Fund from the fall in the share portfolio, contributing approximately 1%

Similar to the June quarter, being non-benchmark assisted performance (principally not being compelled to own banks), with the average company outperforming the cap weighted index. Consumer discretionary exposures **Super Retail, Harvey Norman, News Corporation, Nick Scali, oOH!Media, Star Entertainment Group** and **Bapcor** all featured in the top 10 positive contributors over the quarter as did **Boral, Virtus Health** and not owning **Commonwealth Bank. Unibail Rodamco-Westfield** was the biggest detractor, on debt concerns, followed by **AMP**, after a tone-deaf management appointment and disappointing capital return. **Ampol** (formerly Caltex), **Origin Energy** and **Woodside** reversed some of the June quarter's strong performance, as the market become concerned with second-wave effects on the oil demand recovery story, most evident in the case of Ampol with Melbourne's second lockdown. Other detractors included non-bank financials **IAG, IOOF, NIB Insurance** as well as not owning **Fortescue Metals**.

In the case of oil-exposed names including Oil Search, Woodside and Origin Energy, as well as other downstream oil-exposed names including Ampol and Viva Energy, we expect the successful development of an effective vaccine would drive a normalisation of demand and, in turn, oil prices. We further expect the significant reduction in capital expenditure across the industry to risk future supply tightness and a possible over-shooting of prices. We elaborate on this further in our quarterly insights. In contrast, we expect Vale's dam-failure and COVID-disrupted supply to normalise, with iron ore prices to follow, having remained elevated above normal levels throughout this period. To this end, we have seen Brazil exports above pre-disrupted 2018 levels for the first time since early 2019. If this is sustained, we would expect iron ore prices to begin their reversion.

Figure 13: monthly iron ore exports - Brazil



Source: UBS

The portfolio’s **non-benchmark value and contrarian style** has been a headwind over the past few years and in the initial stages of the COVID-19 downturn. Investors have gravitated towards large capitalisation quality and growth stocks, even more so as interest rates have approached zero. This has only served to increase our resolve and belief in taking a long-term view based on sustainable free cash flow combined with low market expectations. 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. At the same time, the opportunity for meaningful absolute and relative performance is significant.

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

Additional Performance Detail: Sources of Return

FY Performanceⁱ (%) (inc. franking)	21TD	2020	2019	2018	2017	2016	2015	2014	2013	2012	10 Years (p.a.)
Underlying Share Portfolio	-3.9	-9.3	8.4	7.4	23.5	7.0	9.5	16.3	36.0	-3.4	8.5
Hedge Overlay	1.0	3.9	-0.9	-2.3	-5.6	-0.9	-1.7	-3.5	-9.3	2.6	-1.3
Fund Return (before fees)	-2.9	-5.4	7.5	5.1	17.9	6.1	7.8	12.8	26.7	-0.8	7.2
Fund Return (after fees)	-3.2	-6.3	6.5	4.1	16.8	5.1	6.8	11.8	25.6	-1.8	6.2

FY Performanceⁱ (%) (before fees, inc. franking)	2020	2020	2019	2018	2017	2016	2015	2014	2013	2012	10 Years (p.a.)
Underlying Share Portfolio	-3.9	-9.3	8.4	7.4	23.5	7.0	9.5	16.3	36.0	-3.4	8.5
ASX200	-0.1	-6.5	13.2	14.5	15.5	2.2	7.2	18.9	24.3	-5.1	8.4
Excess Return	-3.8	-2.8	-4.8	-7.1	8.0	4.8	2.3	-2.7	11.7	1.7	0.1

FY Performanceⁱ (%) (after fees)	21TD	2020	2019	2018	2017	2016	2015	2014	2013	2012	10 Years (p.a.)
Income	1.1	5.2	5.8	5.5	6.2	5.9	5.6	5.8	7.8	7.6	6.4
Franking	0.5	1.2	2.2	1.5	1.6	2.1	1.9	1.7	2.3	2.5	2.0
Growth	-4.8	-12.7	-1.4	-2.8	9.0	-2.9	-0.7	4.3	15.5	-11.9	-2.2
Fund Return (after fees)	-3.2	-6.3	6.5	5.1	16.8	5.1	6.8	11.8	25.6	-1.7	6.2

FY Performanceⁱ (%) (after fees, inc. franking)	21TD	2020	2019	2018	2017	2016	2015	2014	2013	2012	10 Years (p.a.)
Fund Return (before fees)	-2.9	-5.4	7.5	5.1	17.9	6.1	7.8	12.8	26.7	-0.8	7.2
70% ASX200/30% Bank Bills	0.0	-3.6	9.9	10.6	11.3	2.2	6.0	14.0	17.8	-2.1	6.9
Excess Return (before fees)	-3.0	-1.9	-2.4	-4.4	6.6	3.9	1.8	-1.2	8.9	1.3	0.4
Excess Return (after fees)	-3.2	-2.7	-3.4	-5.4	5.5	2.9	0.8	-2.2	7.7	0.4	6.2

Monthly Distribution Detail: Cents per Unit

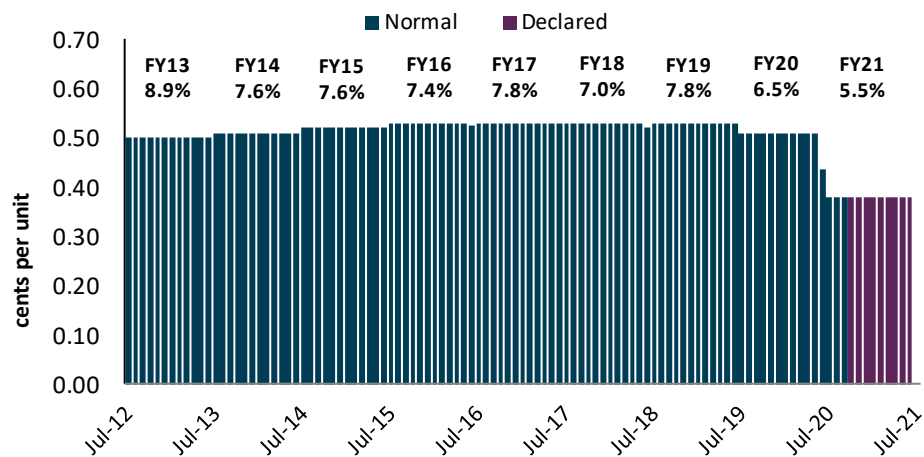
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Total	Franking
FY2013	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.29	6.79	2.26
FY2014	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.52	6.13	1.98
FY2015	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	6.24	2.20
FY2016	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	0.44	6.05	1.40
FY2021	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	0.38	4.56	1.00

Highlighted data are estimates at the date of this report.

Monthly income will be 0.38 cents per unit at least through to May 2021...

and the franking level is projected to be in the 60-70% range

Figure 14: Monthly Income from \$100,000 invested in July 2012ⁱⁱⁱ



Source: Merlon, FY21 estimate, FY Yield based on monthly distribution plus franking credits divided by opening unit price, excludes bonus income in FY13 and FY14.

Links to Previous Research

[Long-term Dividend Opportunity the Main Game](#)

[Oil - Pricing in More Realistic Recovery](#)

[COVID-19 Roadmap](#)

[Trade war – winners, losers and...is it over?](#)

[Why Telstra could be worth less than \\$2](#)

[Good Companies not Always Good Investments](#)

[The AMP Valuation Case](#)

[Iron Ore: Supply Disruption is Temporary](#)

[A Case Study in Poor Capital Allocation](#)

[Trade Wars and the Peak of the Chinese Growth Model](#)

[Some More Thoughts on Telstra](#)

[Rethinking Post Retirement Asset Allocation](#)

[Amazon Revisited - Muted Impact So Far](#)

[Some Thoughts on Asset Prices](#)

[Digital vs. Traditional Media - A Global Trend](#)

[Value Investing - An Australian Perspective: Part III](#)

[Oil: The Cycle Continues](#)

[Value Investing - An Australian Perspective: Part II](#)

[Telstra Revisited](#)

[Value Investing - An Australian Perspective: Part I](#)

[The Case for Fairfax Media Over REA Group](#)

[Some Thoughts on Australian House Prices](#)

[Amazon Not Introducing Internet to Australia](#)

[Iron Ore is Well Above Sustainable Levels](#)

[Boral's High Priced Acquisition of Headwaters](#)

Fund Details[^]

Fund size	\$ 443m	Merlon FUM	\$ 895m
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, 30 September 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.

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 0.5%, Year 1.2%, 3 Years 1.6% p.a., 5 Years 1.6% p.a., 7 Years 1.7% p.a., 10 Years 2.0% p.a.

ASX200 Franking[^]: Month 0.1%, Qtr 0.4%, FYTD 0.4%, Year 1.0%, 3 Years 1.4% p.a., 5 Years 1.4% p.a., 7 Years 1.5% p.a., 10 Years 1.5% p.a.

[^] Source: Fidante Partners Limited, 30 September 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 in FY13 and assumes no bonus income in FY21 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

Unless otherwise specified, any information contained in this publication is current as at the date of this report and is provided by Merlon Capital Partners Pty Ltd ABN 94 140 833 683, AFSL 343 753 (Merlon), the investment manager of the Merlon Australian Share Income Fund ARSN 090 578 171 (Fund). Fidante Partners Limited ABN 94 002 835 592 AFSL 234668 (Fidante Partners) is the responsible entity and issuer of interests in the Fund. The information in this publication should be regarded as general information and not financial product advice, and has been prepared without taking into account of any person's objectives, financial situation or needs. Because of that, each person should, before acting on any such information, consider its appropriateness, having regard to their objectives, financial situation and needs. Each person should obtain and consider the Product Disclosure Statement (**PDS**) and any additional information booklet (**AIB**) for the Fund before deciding whether to acquire or continue to hold an interest in the Fund. A copy of the PDS and any AIB can be obtained from your financial adviser, our Investor Services team on 13 51 53, or on our website www.fidante.com.au. Please also refer to the Financial Services Guide on the Fidante Partners website. Past performance is not a reliable indicator of future performance. Neither your investment nor any particular rate of return is guaranteed. The information contained in this document is not intended to be relied upon as a forecast and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy, nor is it investment advice. If you acquire or hold the product, we, Fidante Partners or a related company will receive fees and other benefits which are generally disclosed in the PDS or other disclosure document for the Fund. Neither Fidante Partners nor a Fidante Partners related company and its respective employees receive any specific remuneration for any advice provided to you. However, financial advisers (including some Fidante Partners related companies) may receive fees or commissions if they provide advice to you or arrange for you to invest in the Fund. Merlon, some or all Fidante Partners related companies and directors of those companies may benefit from fees, commissions and other benefits received by another group company.