



Merlon Income Strategy

Merlon Australian Share Income Fund

Quarterly Report

December 2020

Contents

Reinventing Value Investing	3
The Merlon approach to Corporate Governance	12
Market Outlook	33
Portfolio Positioning	35
December Quarter Portfolio Activity	39
December Quarter Market & Portfolio Review	40

Analyst:

Hamish Carlisle



Our approach to value investing has always been different...

...and our process deals with many of the contemporary issues facing the style

Reinventing Value Investing

We were interested to read NYU Professor Aswath Damodaran's [series of articles](#) on value investing that advocated a ***"New Paradigm for Value Investing"***. We thought it would be worthwhile to reflect on our approach and whether it needed to be refined to incorporate the various changes Damodaran advocates.

In working through this exercise, most notable was the extent to which Damodaran's suggested changes are aligned with our (now more than 10 year old) approach to investing. Consistent with Damodaran's thinking:

We don't pin our hopes on price-to-earnings or price-to-book ratios but rather focus on cash-flow, growth (emphasis on sustainability) and risk (valuation is always a range).

We are not averse to forecasting, provided we acknowledge associated uncertainties.

In contrast many value investors have tended to avoid growth companies where you have to grapple with forecasting in favour of mature companies with tangible assets.

"Margin of safety" is not our substitute risk measure. Rather we combine our proprietary valuation signal based on sustainable-free-cash-flow with a "Conviction" score which considers risk to our base case valuations but most importantly reflects our view of risk bias to consensus expectations. We measure portfolio risk statistically on a daily basis and weigh large exposures against relevant Conviction scores.

We absolutely never take accounting numbers at face value with our focus is on the cash flow statement rather than measures of "advertised" earnings. Listed companies do a good job singing the virtues of such advertised metrics often with advisers, brokers, analysts, journalists and other commentators cheering on from the sidelines. Often these advertised metrics form the basis for variable remuneration prompting management and board members to join the chorus.

We are appropriately diversified with strict single stock, sector and liquidity limits that give risk to a portfolio of 30-40 names. Our reasoning for maintaining this level of diversification has always been built on the presumption that any investment, no matter how well researched is exposed to mistakes.

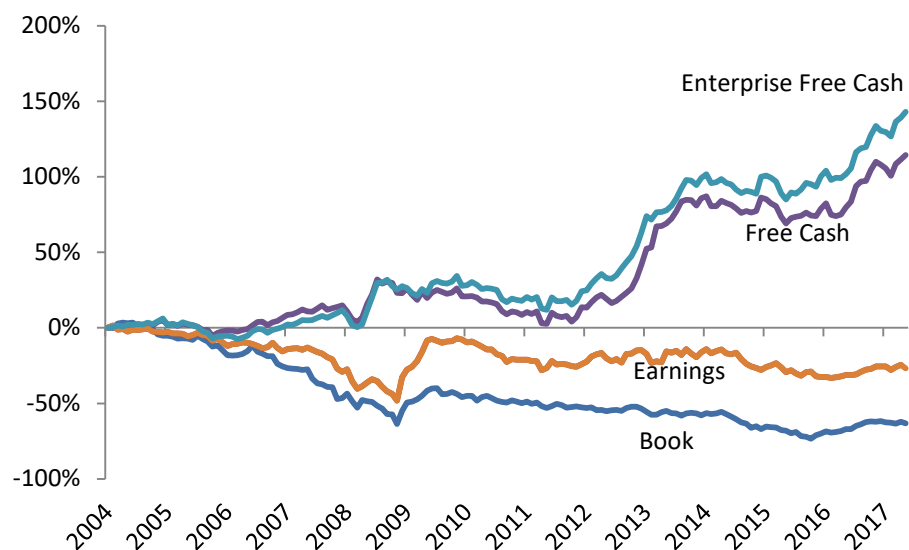
We recognise that markets are mostly efficient and that cheap stocks are always cheap for a reason. So we spend most of our time trying to understand why stocks are excessively cheap or expensive and asking ourselves how our views differ from popular opinion. We reflect this risk through our "Conviction Scores"

In summary, we are not "traditional" value investors and our approach has been consistent through time. While we need to constantly test and refine our process, at its core is a valuation basis premised on a range of long-term sustainable-free-cash-flow scenarios combined with an assessment of whether market expectations have become too pessimistic.

Historical Context

We wrote a series of articles in 2017 providing some perspectives on value investing in Australia. In the [first paper](#) we concluded that value investing on the basis of free-cash-flow has performed well through a number of market cycles and has displayed low levels of volatility when compared to traditional classifications of value such as earnings, book value and dividends.

Figure 1: Returns - “Value” Portfolios Relative to “Glamour” Portfolios
(Australian Data, March 2004 to August 2017)



Source: Merlon Capital Partners. Portfolios are formed using four valuation ratios: free-cash-flow-to-price (F/P); enterprise-free-cash-flow-to-enterprise-value (EF/EV); earnings-to-price (E/P) and book value-to-market (B/M). Portfolios are formed at the end of each month by sorting on one of the four ratios and then computing equally-weighted returns for the following month. The “value” portfolios contain firms in the top one third of a ratio and the “glamour” portfolios contain firms in the bottom third. The analysis is based on S&P/ASX200 constituents and the raw data is from Bloomberg.

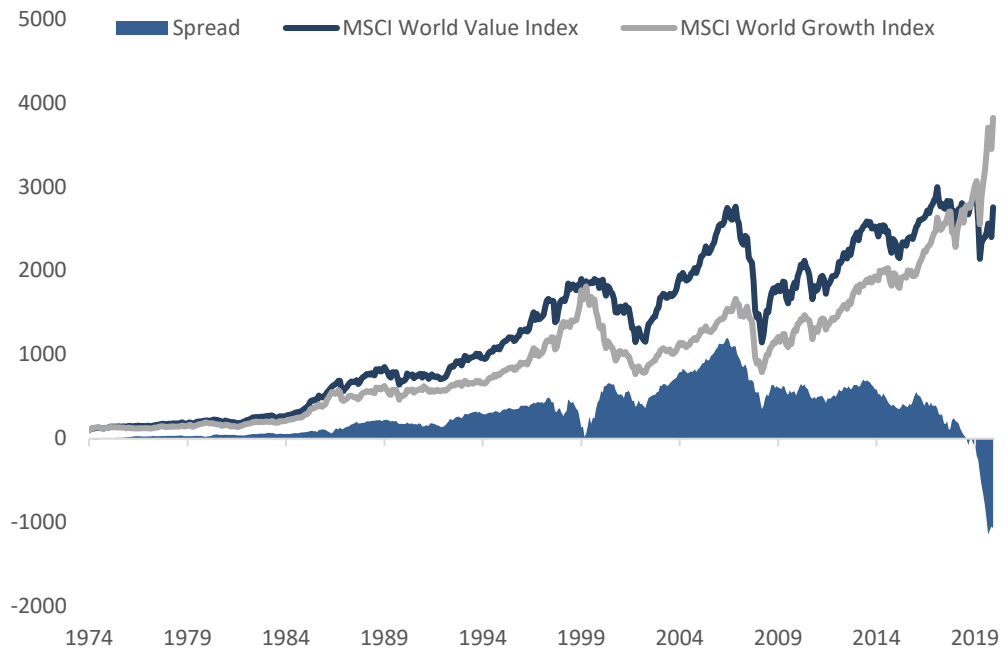
In the [second paper](#), we began to explore the question of **why** value strategies based on free-cash-flow outperform the broader market. Consistent with our philosophy, we presented findings that show a linkage between value investing on the basis of free-cash-flow and earnings quality and went on to dismiss the notion that value investing is “riskier” than passive alternatives.

In the [third paper](#), we discussed some behavioural biases in investor risk assessments and expectations. We also point to various elements of the Merlon investment process, structure and culture that are aimed at minimising our exposure to these biases.

Value investing on the basis of free-cash-flow has performed well...

Since that time we have seen marked underperformance of “value” strategies relative to “growth” strategies across the globe. Among other indices this is evident in the spread between the MSCI World Value Index and the MSCI World Growth Index.

Figure 2: “Growth” vs “Value” - A Longer Term Perspective



Source: Bloomberg, MSCI World Growth and Value index returns. 31 December 2020.

The extent of underperformance has prompted many commentators and institutional investors to question the role of value investing in portfolio construction.

Damodaran’s “Musings on Markets”

“I believe that value investing has lost its edge, partly because of its dependence on measures and metrics that have become less meaningful over time and partly because the global economy has changed, with ripple effects on markets. To rediscover itself, value investing needs to get over its discomfort with uncertainty and be more willing to define value broadly, to include not just countable and physical assets in place but also investments in intangible and growth assets.”

Aswath Damodaran, 23 Oct-2020

Stern School of Business at NYU

On 23 October 2020, NYU Professor Aswath Damodaran published the third in [series of articles](#) on value investing the final of which we have reprinted below.

Traditional value investing has struggled for an extended period of time...

Value Investing III: Requiem, Rebirth or Reinvention?

If you have had the endurance to make your way through my first two posts on value investing, I compliment you on your staying power, but I am sure that, if you are a value investor, you have found my take on it to be unduly negative. In this, my third post, I want to explain why value investing is in trouble and point to ways in which it can be reinvented, to gain new life. I am sure that many of you will disagree both with my diagnosis and my solutions, but I welcome your points of view.

Value Investing: Has it lost its way?

I have never made the pilgrimage to the Berkshire Hathaway meetings, but I did visit Omaha, around the time of the annual meeting, a few years ago, to talk to some of the true believers who had made the trek. I do not think that I will be invited back again, because I argued in harsh terms that value investing had lost its way at three levels.

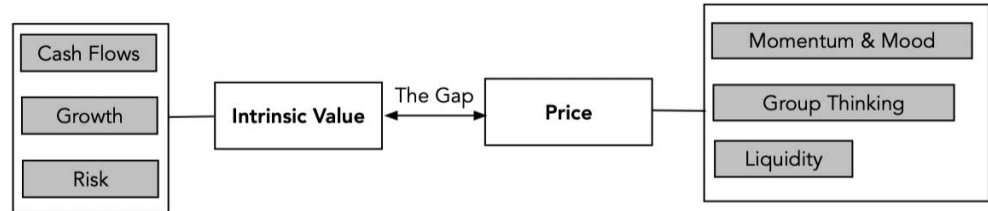
1. *It has become rigid:* *In the decades since Ben Graham published Security Analysis, value investing has developed rules for investing that have no give to them. Some of these rules reflect value investing history (screens for current and quick ratios), some are a throwback in time, and some just seem curmudgeonly. For instance, value investing has been steadfast in its view that companies that do not have significant tangible assets, relative to their market value, and that view has kept many value investors out of technology stocks for most of the last three decades. Similarly, value investing's focus on dividends has caused adherents to concentrate their holdings in utilities, financial service companies and older consumer product companies, as younger companies have shifted away to returning cash in buybacks.*
2. *It has become ritualistic:* *The rituals of value investing are well established, from the annual trek to Omaha, to the claim that your investment education is incomplete unless you have read Ben Graham's Intelligent Investor and Security Analysis to an almost unquestioning belief that anything said by Warren Buffett or Charlie Munger has to be right.*
3. *It has become righteous:* *While investors of all stripes believe that their "investing ways" will yield payoffs, some value investors seem to feel entitled to high returns because they have followed all of the rules and rituals. In fact, they view investors who deviate from the script as shallow speculators, but are convinced that they will fail in the "long term".*

Put simply, value investing, at least as practiced by some of its advocates, has evolved into a religion, rather than a philosophy, viewing other ways of investing as not just misguided, but wrong and deserving of punishment.

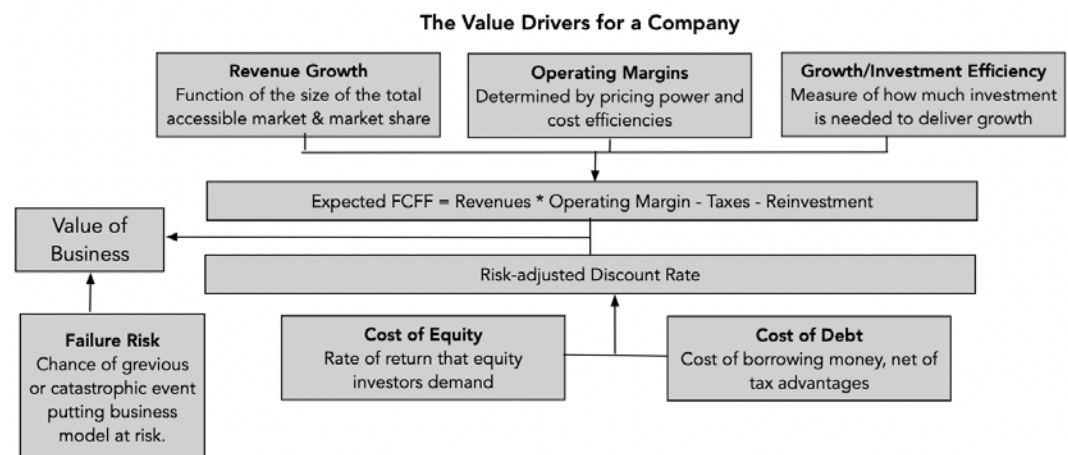
A New Paradigm for Value Investing

For value investing to rediscover its roots and reclaim its effectiveness, I believe that it has to change in fundamental ways. As I list some of these changes, they may sound heretical, especially if you have spent decades in the value investing trenches.

1. Be clearer about the distinction between value and price: While value and price are often used interchangeably by some market commentators, they are the results of very different processes and require different tools to assess and forecast.



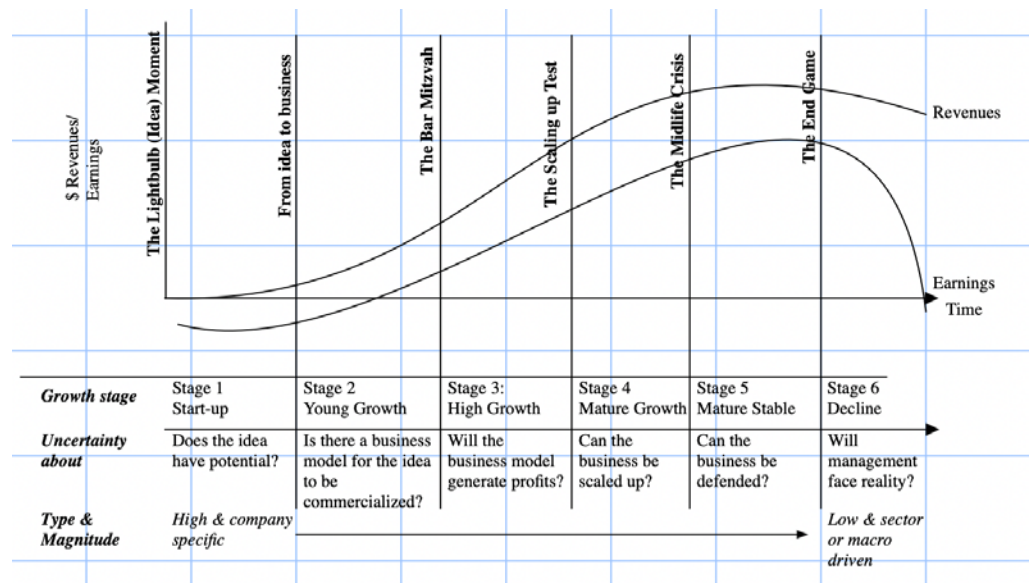
Value is a function of cash flows, growth and risk, and any intrinsic valuation model that does not explicitly forecast cash flows or adjust for risk is lacking core elements. Price is determined by demand and supply, and moved by mood and momentum, and you price an asset by looking at how the market is pricing comparable or similar assets. I am surprised that so many value investors seem to view discounted cash flow valuation as a speculative exercise, and instead pin their analysis on comparing comparing on pricing multiples (PE, Price to book etc.). After all, there should be no disagreement that the value of a business comes from its future cash flows, and the uncertainty you feel about those cash flows, and as I see it, all that discounted cash flow valuation does is bring these into the fold:



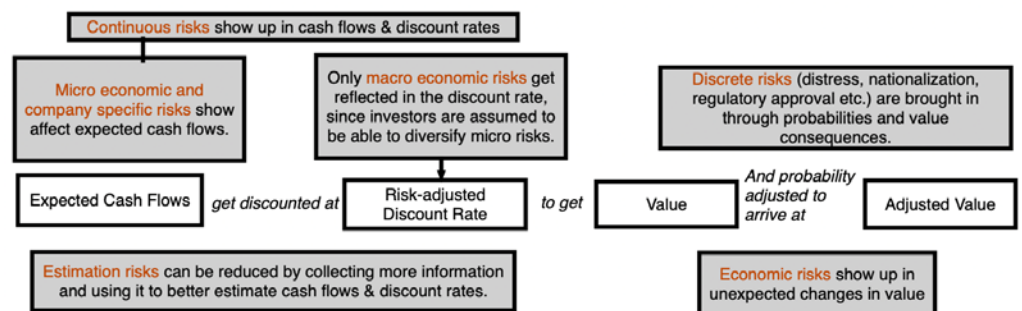
It is true that you are forecasting future cash flows and trying to adjust for risk in intrinsic valuation, and that both exercises expose you to error, but I don't see how using a pricing ratio or a short cut makes that error or uncertainty go away.

2. Rather than avoid uncertainty, face up to it: Many value investors view uncertainty as "bad" and "something to be avoided", and it is this perspective that has led them away from investing in growth companies, where you have to grapple with forecasting the future and towards investing in mature companies with tangible assets. The truth is that

uncertainty is a feature of investing, not a bug, and that it always exists, even with the most mature, established companies, albeit in smaller doses.

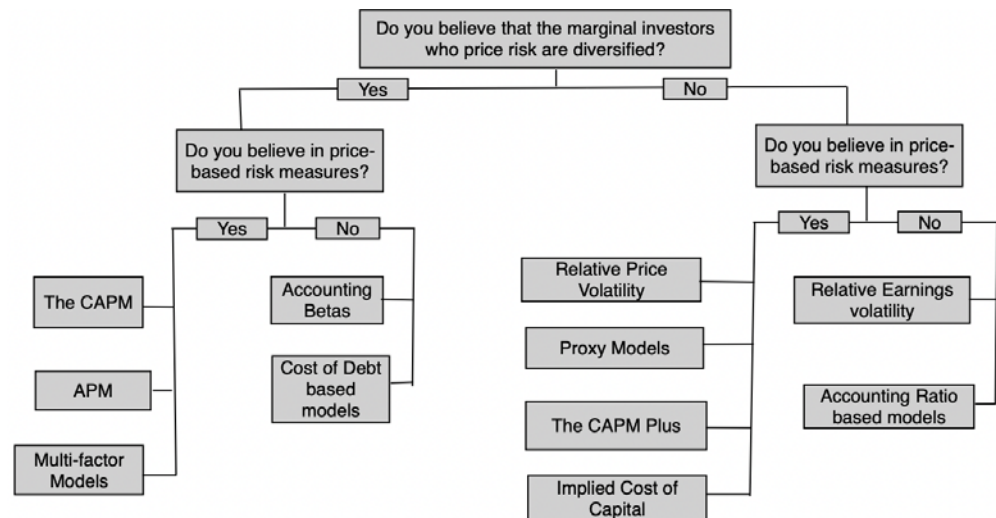


While it is true that there is less uncertainty, when valuing more mature companies in stable markets, you are more likely to find those mistakes in companies where the uncertainty is greatest about the future, either because they are young or distressed, or because the macroeconomic environment is challenging. In fact, uncertainty underlies almost every part of intrinsic value, whether it be from micro to macro sources:

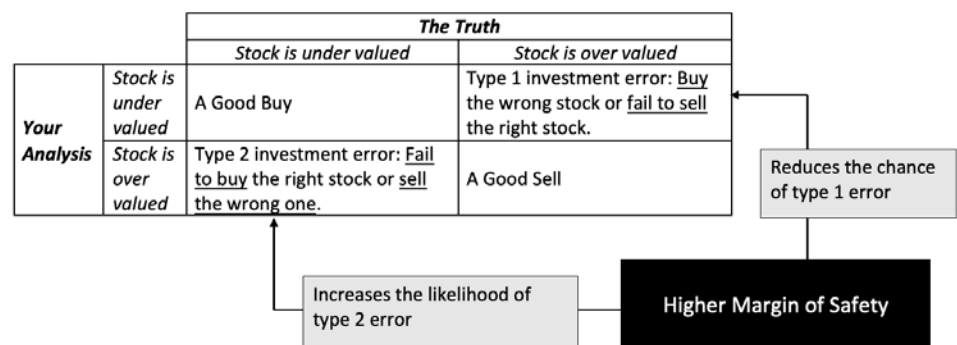


To deal with that uncertainty, value investors need to expand their tool boxes to include basic statistical tools, from probability distributions to decision trees to Monte Carlo simulations.

3. Margin of safety is not a substitute risk measure: I know that value investors view traditional risk and return models with disdain, but there is nothing in intrinsic value that requires swearing allegiance to betas and modern portfolio theory. In fact, if you don't like betas, intrinsic valuation is flexible enough to allow you to replace them with your preferred measures of risk, whether they be based upon earnings, debt or accounting ratios.



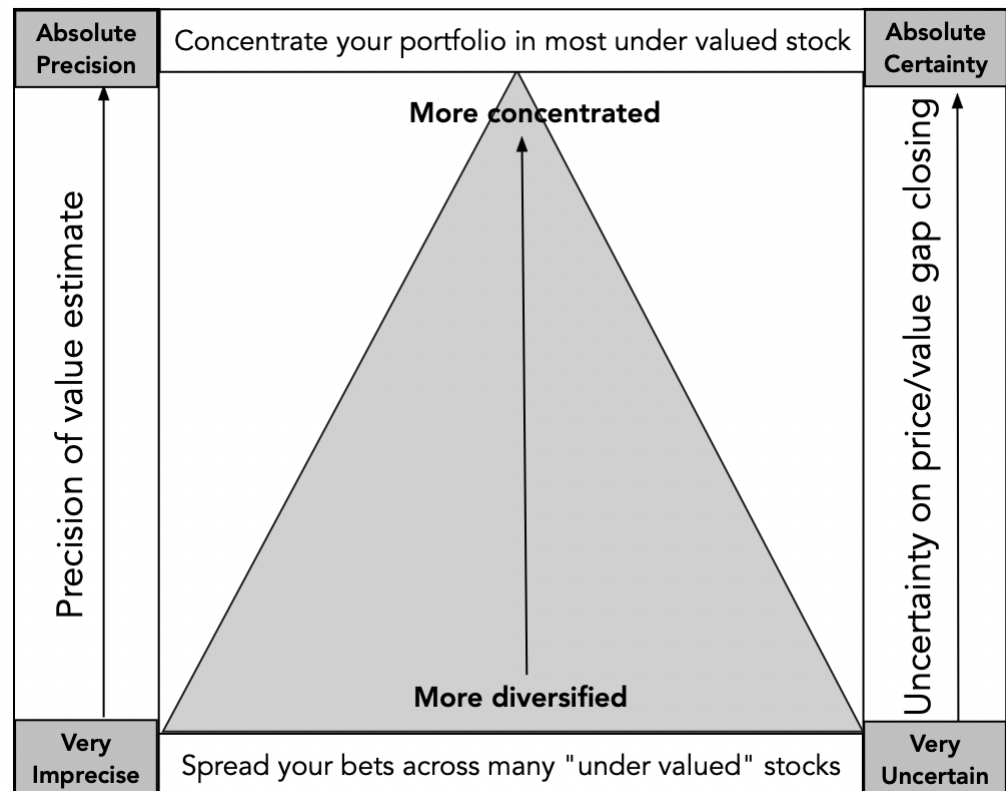
For those value investors who argue that the margin of safety is a better proxy for risk, it is worth emphasizing that the margin of safety comes into play only after you have valued a company, and to value a company, you need a measure of risk. When used, the margin of safety creates trade offs, where you avoid one type of investment mistake for another:



As to whether having a large MOS is a net plus or minus depends in large part on whether value investors can afford to be picky. One simply measure that the margin of safety has been set too high is a portfolio that is disproportionately in cash, an indication that you have set your standards so high that too few equities pass through.

4. Don't take accounting numbers at face value: It is undeniable that value investing has an accounting focus, with earnings and book value playing a central role in investing strategies. There is good reason to trust those numbers less now than in decades past, for a few reasons. One is that companies have become much more aggressive in playing accounting games, using pro forma income statements to skew the numbers in their favor. The second is that as the center of gravity in the economy has shifted away from manufacturing companies to technology and service companies, accounting has struggled to keep up. In fact, it is clear that the accounting treatment of R&D has resulted in the understatement of book values of technology and pharmaceutical companies.

5. You can pick stocks, and be diversified, at the same time: While not all value investors make this contention, a surprisingly large number seem to view concentrated portfolios as a hallmark of good value investing, arguing that spreading your bets across too many stocks will dilute your upside. The choice of whether you want to pick good stocks or be diversified is a false one, since there is no reason you cannot do both. After all, you have thousands of publicly traded stocks to pick from, and all that diversification requires is that rather than put your money in the very best stock or the five best stocks, you should hold the best thirty or forty stocks. My reasoning for diversification is built on the presumption that any investment, no matter how well researched and backed up, comes with uncertainty about the payoff, either because you missed a key element when valuing the investment or because the market may not correct its mistakes. In a post from a few years ago, I presented the choice between concentration and diversification in terms of those two uncertainties, i.e., about value and the price/value gap closing:



I think that value investors are on shaky ground assuming that doing your homework and focusing on mature companies yield precise valuations, and on even shakier ground, when assuming that markets correct these mistakes in a timely fashion. In a market, where even the most mature of companies are finding their businesses disrupted and market momentum is augmented by passive trading, having a concentrated portfolio is foolhardy.

6. *Don't feel entitled to be rewarded for your virtue:* Investing is not a morality play, and there are no virtuous ways of making money. The distinction between investing and speculating is not only a fine one, but very much in the eyes of the beholder. To hold any investing philosophy as better than the rest is a sign of hubris and an invitation for markets to take you down. If you are a value investor, that is your choice, but it should not preclude you from treating other investors with respect and borrowing tools to enhance your returns. I will argue that respecting other investors and considering their investment philosophies with respect can allow value investors to borrow components from other philosophies to augment their returns.

Moving Forward

Investors, when asked to pick an investment philosophy, gravitate towards value investing, drawn by both its way of thinking about markets and its history of success in markets. While that dominance was unquestioned for much of the twentieth century, when low PE/PBV stocks earned significantly higher returns than high PE/PBV stocks, the last decade has shaken the faith of even diehard value investors. While some in this group see this as a passing phase or the result of central banking overreach, I believe that value investing has lost its edge, partly because of its dependence on measures and metrics that have become less meaningful over time and partly because the global economy has changed, with ripple effects on markets. To rediscover itself, value investing needs to get over its discomfort with uncertainty and be more willing to define value broadly, to include not just countable and physical assets in place but also investments in intangible and growth assets.

Adrian Lemme**Neil Margolis****Hamish Carlisle****Andrew Fraser****Ben Goodwin****Caroline Mullin****Joey Mui**

The Merlon Approach to Corporate Governance

In 2019 we outlined our views on quality and how it fits in our investment process ([Quality in the Merlon Process](#)). With governance being a key focus in our assessment of the overall quality of company, this paper expands on our previous discussion and details how governance is integrated into our investment thinking. Future papers will cover how environmental and social factors are incorporated into our investment process. The key points in this paper are:

The role of governance is highly integrated into our process. We explicitly rate Governance & Management as part of our Qualitative Scorecard. We believe companies rating higher on our Qualitative Scorecard will tend to generate higher returns on capital through time and therefore convert a greater proportion of accounting profits into free-cash-flow.

Our relentless focus on free-cash-flow can identify governance concerns. Free-cash-flow is the basis upon which we value all companies. Companies with significant divergence between advertised performance metrics and free-cash-flow often suffer from poor governance and are often expensive relative to sustainable free-cash-flow.

We do not screen out companies based on governance. Rather, we seek to determine whether the upside of an investment is sufficient given the risk of permanent loss including permanent losses attributable to potential governance failures.

We seek to identify market misperceptions about governance. We believe markets are mostly efficient and therefore think popular governance views are usually discounted into stock prices. Rather it is through identifying market misperceptions about governance that we think we have the capacity to generate excess returns.

We have a strong track record of engaging on governance issues. We regularly engage with management and boards to understand and encourage alignment and strong representation of shareholders. Appendix 1 discusses our approach to engagement with portfolio companies and Appendix 2 contains several case studies demonstrating our engagement track record.

The primary focus of the board should be to address agency problems...

Higher quality companies tend to generate higher returns on capital and free-cash-flow...

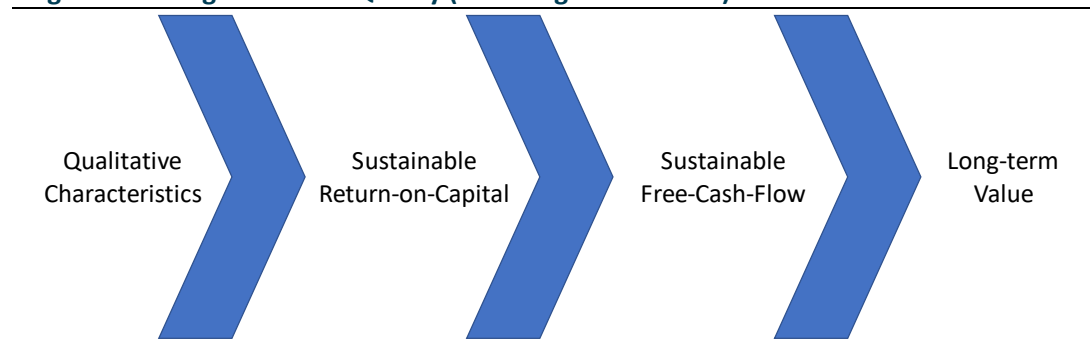
...and governance is an important factor in considering the overall quality of a company

Governance and Shareholder Outcomes

At Merlon we adopt a broad definition of governance as the responsibility of the board and management to represent the interests of shareholders over the long-term. Our view is that the primary focus of the board is to address agency problems that emerge when management and shareholders have conflicting interests. In assessing management and governance we closely consider (a) the personal integrity and track records of the individuals involved, including any dominant personalities, (b) long-term alignment; and (c) culture.

In 2019 we authored a paper ([Quality in the Merlon Process](#)) concluding that companies of higher quality (favourable industry structure, demonstrable competitive advantage, good governance and management) can generally be expected to drive sustainably higher returns on capital and free-cash-flow.

Figure 3: Linkage Between Quality (including Governance) & Value



Source: Merlon Capital Partners

Drilling down into governance, we consider it to be an important factor when assessing the overall quality of a company due to its significant influence on capital allocation and management behavior. For example, if the incentive structure set by the board is ill-conceived, it can result in poor capital allocation decisions and/or management being too focused on maximising short-term outcomes at the expense of long-term shareholder value.

Case Study – Boral's Acquisition of Headwaters

Companies that allocate capital poorly destroy shareholder value. For example, Boral's acquisition of Headwaters in 2016 for \$3.7b resulted in a significant destruction of shareholder value as recently acknowledged by Boral through its recent \$1.1b write-down of Headwaters goodwill. The specific failings in this case included company reliance on over-optimistic forecasts and synergies, whether appropriate board challenge of management views took place and the integration of the businesses post acquisition. We publicly commented on this transaction in 2016 ([Boral's High Price Acquisition of Headwaters Incorporated](#)). We exited the position within 12 months when the market became more complacent about the merits of the transaction and the share price recovered.

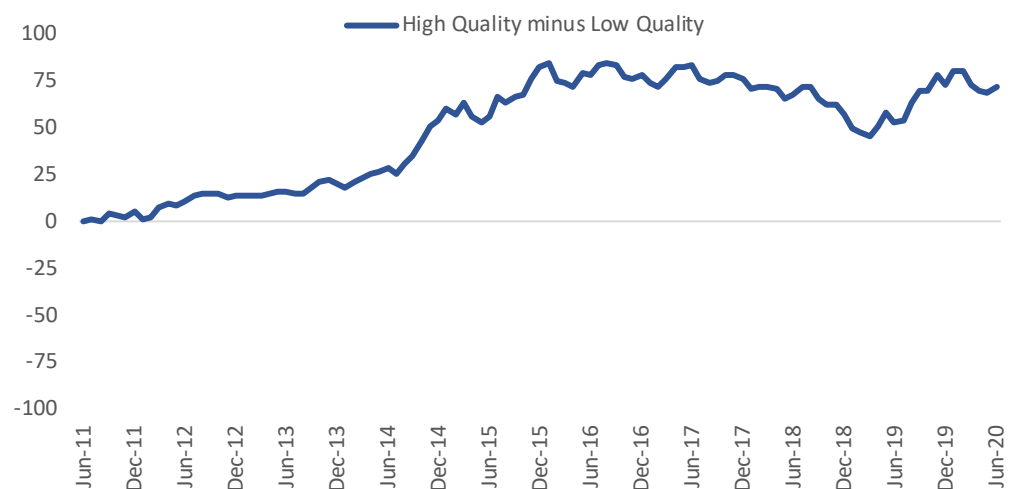
Governance is a determinant of quality and quality stocks have outperformed in recent years...

Whether we are in a “quality valuation bubble” remains to be seen...

There are many empirical studies that show that good governance structures and practices are associated with better stock performance. For example, Gompers, Ishii and Metrick, authors of [“Corporate governance and equity prices”](#), found a strong relationship between corporate governance (as determined by 24 different provisions) and stock returns.¹

Using our proprietary quality scores (of which governance represents a sizeable component) as a measure of quality, high quality stocks have outperformed low quality stocks (Figure 2).

Figure 4: Top tercile minus bottom tercile quality stocks



Source: Bloomberg, Merlon, calculated using Merlon’s quality rank, top tercile minus bottom tercile quality stocks rebalanced monthly

However, we would caution that the period since Merlon’s inception has been defined by historically low and declining interest rates. We remain mindful that valuations for quality stocks remain above historic norms. This potential “bubble” in quality stocks increases the importance of long-term fundamental valuation for investors, including the integration of governance views and determining where the market might be overly optimistic or pessimistic in relation to governance and other quality factors.

¹ Gompers. A, Ishii. J, Metrick A., Corporate governance and equity prices, *NBER Working Paper Series*, Working Paper 8449, 2001

*We measure
“quality” using a
systematic and
structured
manner...*

*There is an
interrelationship
between
governance and
other components
of our scorecard...*

The Merlon Qualitative Scorecard

As also detailed in *Quality in the Merlon Process*, we assess quality through our qualitative scorecard. This covers *Industry Structure* (score out of 15), *Competitive Advantage* (score out of 9) and *Governance & Management* (score out of 11).

Our *Governance & Management* scorecard is critical in that the existence of a favourable industry structure or company specific competitive advantage may not necessarily result in higher rates of return. For example:

- A firm may trade current returns for investment in market share or other uneconomic growth strategies.
- A firm may forgo returns in the interests of customer satisfaction, employee benefits or executive perks.
- A firm may lack the ability to identify and respond to external change.
- A firm may seek to uneconomically deploy capital to drive “growth for growth’s sake” entering into poorly structured industries or where its competitive advantage is lacking.

Our *Governance & Management* score is decomposed into Governance; Capital Allocation; and Execution. In reality there is an interrelationship between these components with overarching governance processes, structures and cultures driving all elements. Over longer periods, there is also an interrelationship between *Governance and Management* and a firm’s *Competitive Advantage* as well as the choices a firm makes about which *Industry Structures* it chooses compete in.

As can be seen in Table 1, in determining our *Governance & Management* scores we review board composition for diversity and balance of power; examine remuneration models/equity alignment; consider the track records of the companies and individuals concerned; and, seek to understand companies’ strategies to generate acceptable and sustainable returns.

Table 1: Governance & Management Scorecard

<p>Factor: Governance</p> <p>A board's existence is principally to address agency issues that arise between shareholders and management.</p>	<p>What does a score of 5 look like?</p> <ul style="list-style-type: none"> • Independent and well-structured board with appropriate experience, diversity and ability to challenge management • A significant proportion of management and board remuneration is explicitly tied to shareholder returns • Board and management have a strong sense of ownership, are accountable • Adopt sound accounting practices • Avoid related party transactions • Strong shareholder protections • Disclosure is very transparent <p>What does a score of 0 look like?</p> <ul style="list-style-type: none"> • Completely lacking in all the above
<p>Factor: Capital Allocation</p> <p>The essence of this factor is the recognition that companies operating in the interests of their shareholders, whose interest is in maximising their wealth.</p>	<p>What does a score of 3 look like?</p> <ul style="list-style-type: none"> • Company shows a willingness to forgo unprofitable growth & market share • Company actively allocates capital across divisions, measures returns on that capital and remunerates managers on the basis of returns <p>What does a score of 0 look like?</p> <ul style="list-style-type: none"> • Track record of over-paying for acquisitions • History of aggressive pricing strategies to support market share • Lack of understanding of basic investment principles
<p>Factor: Ability to identify change & execute</p> <p>Any external change creates opportunities for profit. The ability to identify and respond to opportunity lies at the core of management capability.</p> <p>To the extent that opportunities are fleeting or subject to first move advantage, speed of response is critical to exploiting business opportunity.</p>	<p>What does a score of 3 look like?</p> <ul style="list-style-type: none"> • Company has a deep understanding of the markets in which it operates and is constantly scanning the environment for changes and opportunities. • Company's scanning mechanisms are less dependent on conventional analysis of economic and market research data and more dependent on direct relationships with customers, suppliers and competitors. • Firm's culture is highly entrepreneurial. • Firm has a history of rapidly and successfully redeploying resources to meet changes in external conditions. <p>What does a score of 0 look like?</p> <ul style="list-style-type: none"> • Completely lacking in all the above

Source: Merlon

Peer Review

All scores are subject to rigorous peer review. A sample of the way in which we present our **Governance & Management** scorecards as part of our peer review process is shown in Figure 3.

Figure 5: Platinum Asset Management Governance & Management scorecard

3. Quality Scorecard – Governance & Management



	Governance	Capital Allocation	Execution	Total Score
Group	<ul style="list-style-type: none"> ✗ Related party risk ✗ Pay skew to short term investment performance ✓ But good ownership alignment 	<ul style="list-style-type: none"> ✓ Not acquisitive 	<ul style="list-style-type: none"> ✗ Long term track record is now under pressure ✗ Underinvestment in distribution ✗ High analyst turnover 	Average tenure PMs = 14 years Analysts = 2 years
	4/5	3/3	2/3	8/11

CEO Compensation Table	FY19 Value	KPIs & comments
Fixed Pay	\$450,000	
Investment Team Plan	\$0 to \$900,000	Weighted average 1 and 3 year performance, 0% attachment point, maximum at 5% outperformance
Profit Share Plan	\$0 to \$1,500,000	Weighted average 1 and 3 year performance, 1% attachment point, maximum at 6% outperformance
CEO Plan	\$0 to \$1,000,000	Financial performance, strategic execution, leadership, risk management, operational effectiveness
Deferred Remuneration Plan	\$0 to \$1,000,000	4 year vesting subject to continuing employment
Market value of equity/performance rights	Neilsons: \$1,190m Clifford: \$155m	252m shares, 60m sold in March 2019 33m shares

7

Source: Annual reports, Merlon

Interrelationship Between Remuneration, Management Tenure & Governance

As part of the peer review presentations, we place emphasis on the remuneration structure of the CEO and key management personnel (Figure 3). The purpose is to understand the alignment with shareholders through short-term and long-term incentives, co-investment in the company and whether the CEO has been selling shares.

Remuneration structures in themselves are a small part of overall assessment of governance processes, structures and cultures but are readily observable and often indicative of broader issues. A poorly designed remuneration structure could well be symptomatic of bigger underlying problems. To quote Warren Buffett on Wells Fargo: “There’s never just one cockroach in the kitchen”.

Similarly, we place emphasis on management tenure as an indicator of where there might be lingering cultural issues.

Management alignment with shareholders is closely scrutinised...

“There is never just one cockroach in the kitchen”...

*“[Merlon] take time
to consider the
issues”*

-Ownership Matters

Third Party Research

Ownership Matters is our primary governance advisor. We also subscribe to ISS and will actively engage with other advisers such as CGI Glass Lewis and ACSI where appropriate.

We have a regular quarterly meeting with Ownership Matters to discuss governance issues but engage with them on specific matters on a much more frequent basis. When assessing governance, we refer to Ownership Matters’ assessment of the key governance concerns for the company and where they rank the company in their ASX 100 or Ex 100 rankings.

“OM helps investors to identify, price and remediate governance risk in the companies they own. Perverse management incentives can drive dodgy accounting – where this is overseen by a dopey board, it can be a dangerous combination where there is little margin for safety.

We always look forward to being interrogated by Merlon on the risks we identify – they take the time to consider the issues.

- Dean Paatsch, Ownership Matters

It’s important to recognise that our views can and often do differ from research providers and popular consensus.

Case Study – Views that Differ from Popular Opinion

Ownership Matters and the market have a very negative view of Harvey Norman’s governance owing to concerns including, but not limited to, executive pay, lack of independent directors, related party transactions etc.

While we acknowledge some of these concerns, we feel they need be weighed against positive steps to improve its governance (appointment of two new independent directors, tightening its capital allocation etc.) and the cultural benefits of having board members very well aligned to shareholders through their ~33% combined holding in the company. We see this alignment evidenced in the positive steps taken in recent years to unlock shareholder value through distributing excess franking credits.

A focus on free-cash-flow for valuation can identify governance issues...

The Merlon Valuation Approach

Now more than ever, traditional classifications of “value” based on accounting earnings, net assets and dividends are readily manipulated by management. The relatively recent ramp up in dividend payout ratios and the growing divergence between statutory and “underlying” earnings are examples of this.

Our approach to dealing with this issue is to classify stocks based on their capacity to generate cash flow over and above that needed to sustain and grow their businesses **free-cash-flow**). The use of **free-cash-flow** rather than accounting earnings, net assets or dividends is important because the measure is less readily manipulated by management and less readily observable by investors.

Our process tends to highlight situations where there is a significant divergence between management measures of performance and **free-cash-flow**. Such gaps emerge where companies:

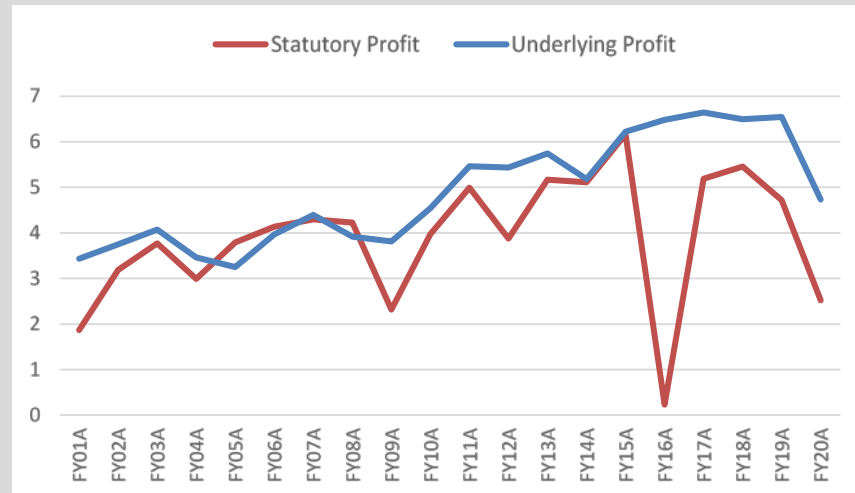
- overestimate the useful lives of their assets causing depreciation and amortisation charges to understate the amount of capital required to sustain and grow their businesses;
- repeatedly report of “one-off” or “significant” items outside “underlying” measures of performance; and/or
- require a significant amount of working capital to sustain their businesses.

Again, Merlon’s approach to dealing with this issue is to classify stocks based on their capacity to generate cash flow over and above that needed to sustain and grow their businesses **free-cash-flow**). However, where key performance measures incorporated into company presentations are remuneration models differ from free-cash-flow there may also be governance issues at play.

Case Study – Diverging Management Performance Measures and Free-Cash-Flow

The gap between National Australia Bank’s “underlying profit” and statutory profit has totaled almost \$20 billion over the last 20 years (Figure 6). Further the gap between statutory profit and free-cash-flow has represented an additional \$35 billion.

Figure 6: National Australia Bank statutory and underlying profit (\$b)



Source: Annual reports, Merlon

The widespread use of “underlying” earnings as the basis for determining management incentives is of great concern to us, especially considering the average ASX200 company only converts around 70% of its accounting earnings into free-cash-flow.

Governance, Poor Capital Allocation & Valuation

Poor capital allocation can be an outcome of poor governance. Sometimes, poor capital allocation can be quantified and factored into our estimates of sustainable **free-cash-flow**, which drives valuation.

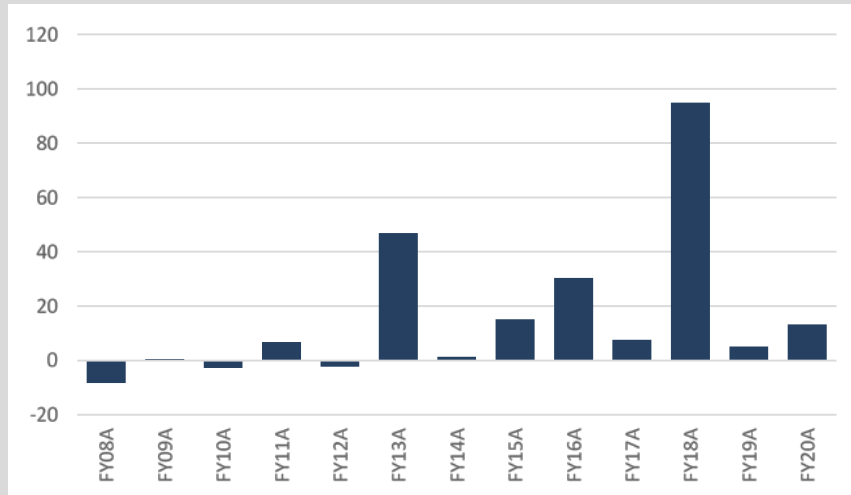
A divergence between cash flow and accounting profit can be a governance “red flag”...

We can sometimes factor governance concerns into valuation...

Case Study – Persistent non-core Investing Activities

Harvey Norman is an example where governance concerns can be explicitly factored into our estimate of sustainable free cash flow and valuation. Up until recently, there were investments in “non-core” activities, such as a dairy farm and mining camp accommodation, via joint venture and other structures, averaged ~\$30m pa since 2013 (Figure 7).

Figure 7: Harvey Norman loans to JV’s and related/unrelated parties (\$m)



Source: Annual reports, Merlon. Positive values denote cash outflows and negative values indicate cash inflows.

These investments incurred significant losses and were exited at low values or written off. To account for the risk of further shareholder value destruction, we capitalized \$30m per annum into our assessment of fundamental value, reducing our valuation of Harvey Norman by 5%. This in turn drove a lower portfolio weight.

We made our position clear to the company on several occasions and obtained commitments these investments would reduce. Pleasingly this has materialised through significantly reduced cash outflows in this investing cash flow line during the last two years and so we have removed this impact from our projected free-cash-flow and valuation.

We would add that while frustrating at times, these investments are not overly material and can be far less damaging than very large acquisitions, often in offshore markets, made by CEOs with limited personal investment alongside shareholders.

Our “Conviction Scores” incorporate whether the market is overly pessimistic or optimistic on governance...

The Merlon Conviction Score

A key tenant of Merlon’s investment philosophy is that markets are mostly efficient and that cheap stocks are always cheap for a reason. We are focused on understanding why cheap stocks are cheap. To be a good investment, market concerns need to be priced in or deemed invalid. We incorporate these aspects with a **Conviction Score** that feeds into our portfolio construction framework.

For governance concerns that can be quantified, such as the risk of poor capital allocation, we may apply a more adverse outcome to our downside valuation scenario than our central case valuation. If the share price is already trading below our downside scenario, we may conclude the market is overly pessimistic on governance, leading to a positive conviction bias. Alternatively, if the share price is trading well above our valuation, but we still consider capital allocation risk to be a key issue, this may lead us to have a negative conviction bias.

Not all governance risks can be expressed quantitatively but can still be factored into conviction to the extent that our views on a company’s governance differ to the market and we believe it has the potential to materially impact the investment case.

Case Study – Market underestimating poor capital allocation

We invested in Clydesdale Bank (CYB) when it was demerged from National Australia Bank in 2016 on the basis of self-help cost, capital and de-risking initiatives. However, in June 2018, CYB announced the acquisition of Virgin Money UK with a 61% increase in its share count to effect the merger. We immediately reduced our conviction score to reflect the unsustainable aspects of the Virgin Money business, including rapid market share growth via third parties, a risky expansion into balance transfer credit cards, over-reliance on wholesale and cheap government funding, and an unrealistic cost synergies.

However, the market did not initially share our pessimistic view and the share price rallied from A\$5.50 to over \$6, allowing us time to completely exit the investment at a favourable price. The shares traded at \$2 a year later, even before the COVID-19 impacts.

Other examples of where governance has impacted our conviction include:

- NewsCorp – governance is improving, not being appreciated by the market
- Harvey Norman – governance concerns overstated by the market, strong alignment
- Nick Scali – minor related party risk but overridden by strong alignment
- iiNet – poorly structured and managed sale process

We do not screen out companies based on governance...

...rather, Governance is highly integrated in the Merlon process

Impact of Governance on Portfolio

As described above, through our quality assessment, valuation and conviction, governance concerns directly impact portfolio decisions. Importantly, we do not screen out companies based on governance, preferring to identify whether the upside of an investment is sufficient given the risk of permanent loss from potential governance failures.

Concluding Remarks

Good governance is by no means sufficient on its own to determine company performance. Alternatively, bad governance can erode shareholder value over time, particularly when not priced in by the market. We see this frequently through poor capital allocation decisions, poor handling of takeover approaches and high turnover among talented management.

Having said that, there is an increasing appetite in the market to pay a premium (i.e. employ a lower discount rate) for companies with good governance. By definition, lower discount rates will lead to lower returns and well governed companies might have a higher hurdle to continue outperforming.

The role of governance is highly integrated into our process. We explicitly rate **Governance & Management** as part of our **Qualitative Scorecard**. We believe companies rating higher on our **Qualitative Scorecard** will tend to generate higher returns on capital through time and therefore convert a greater proportion of accounting profits into **free-cash-flow**.

Free-cash-flow is the basis upon which we value all companies. Companies with significant divergence between advertised performance metrics and **free-cash-flow** often suffer from poor governance and are often expensive relative to sustainable **free-cash-flow**.

Importantly, we do not screen out companies based on governance, preferring to identify whether the upside of an investment is sufficient given the risk of permanent loss from potential governance failures. All else equal, we would have a positive **conviction score** where market prices are already below levels consistent with major governance failings. Conversely, if the market is complacent about governance risks, we would be more cautious. It is through identifying market misperceptions about governance that we think we have the capacity to generate excess returns.

Appendix 1: Engagement with Portfolio Companies

Introduction

At Merlon we focus on assessing the sustainability of a company's free-cash-flow because we believe that is the basis on which companies should be valued. We also place emphasis on identifying market misperceptions and on downside valuation scenarios which we reflect in our "Conviction Score".

We incorporate information garnered from engaging with company management, board members, competitors, suppliers, customers and third-party research providers in developing both our assessment of sustainable free-cash-flow and in arriving at Conviction Scores.

We are committed to engaging with portfolio companies on a broad range of issues including ESG where relevant. Engagement activities are carried out routinely by all Merlon portfolio managers and analysts. The outcomes of the engagement are reflected in our research which has a direct relationship with portfolio positioning.

Case studies highlighting our strong engagement track record are outlined in Appendix 2.

Effective Stewardship

Merlon recognises that investment managers play a key role in fulfilling stewardship obligations to ensure responsible management and robust corporate governance practices through engagement activities.

Shareholder stewardship is an assessment of whether a company's senior management and board have, or are likely to act, in the best interests of shareholders. This includes an analysis of historical decision making, management and board effectiveness, remuneration structures, corporate governance, culture, financial controls, the personal integrity and track records of the individuals involved, long-term alignment and culture.

The Financial Services Council introduced its Internal Governance and Asset Stewardship code in January 2018. The code is a disclosure-based standard requiring members to articulate and promote their approach to internal governance and asset stewardship. Whilst Merlon is not required to adopt this code, we recognise the importance of internal governance and asset stewardship and appreciate that as investment managers we have the privilege to engage proactively with companies.

Management Engagement

We believe that engagement (both private and public) can be an important aspect of the investing process. There is usually a distinction between board engagement and management engagement.

Engagement with **management** is focused on understanding the company strategy and assessing the outlook for sustainable free-cash-flow and range of outcomes, including

Merlon has a strong track record of engaging on ESG issues

downside scenarios. Our frequency of engagement with management is naturally higher than with boards. An important part of our process is corroborating usually positive management views with former executives, competitors, suppliers and customers through our extensive independent expert network. We believe that verifying management views, and challenging these perspectives is our obligation as managers of capital.

Board Engagement & Voting

We aim to engage with the **boards** of all companies in which we have invested at least annually, in addition to those in which we might consider investing. The focus is to understand and encourage alignment and strong representation of shareholders.

A significant part of our engagement with boards occurs prior to AGMs. We research the recommendations of the proxy advisors prior to meeting. If we intend to vote against a board recommendation, we discuss this with the company prior to voting. If the board's reasoning is sound, we may consider changing our view, however the engagement and discussion with company is key to understanding their perspective.

In terms of the nature of questions we might ask at a board level, while there will always be some specific to each company, there are some core questions relevant to all as outlined in Table 1 overleaf:

Table 1: Sample of engagement questions

<i>Board composition and functioning</i>	<ul style="list-style-type: none"> • If recently joined, what due diligence was completed prior? • If long-serving, what is the view on appropriate tenure? • What succession planning is in place for executives and the board? • Is there appropriate challenge of the CEO and other executives?
<i>Incentives</i>	<ul style="list-style-type: none"> • How appropriate are the incentives to driving the correct behaviours for the long-term sustainability of the business? • How are management and the board aligned to shareholders and are there minimum shareholdings? • What is the board's attitude to share sales? • Fatalities - is safety a gate for zero bonuses?
<i>Accounting</i>	<ul style="list-style-type: none"> • What is the link between accounting and incentives (use of EBITDA etc.)? • Is the company doing factoring (why, how etc.)?
<i>Capital allocation</i>	<ul style="list-style-type: none"> • How does the board allocate capital and evaluate acquisition opportunities? • What have been the board's best and worst capital allocation decisions? • Is there an example of an investment that didn't go ahead due to the board?
<i>Environmental and social risks</i>	<ul style="list-style-type: none"> • Does the person responsible for ESG report to the board on climate change risk? • Does the board have good oversight on modern slavery risks (awareness of direct suppliers etc)?

Source: Merlon

Approach to Voting

We provide recommendations to institutional clients and to the responsible entity for pooled funds. We draw on the views of Ownership Matters and ISS when determining our voting intentions. While we are inclined to follow the proxy advisors' recommendations, on occasion our views may differ. For example, the proxy advisors recommended voting against many of the Harvey Norman 2019 AGM resolutions. Specifically, they recommended voting for a new independent director who we felt had no relevant experience to offer to the board and would have been extremely disruptive, so we voted in-line with the board recommendation.

We keep records of contentious voting issues, noting how and why we voted either against board recommendations and/or proxy advisors.

In 2019, 91.8% of our voting instructions were made in-line with board recommendations and 8.2% were against.

Third Party Engagement

In addition to **board** engagement and **management** engagement we also engage with third parties including:

- Other shareholders and investors;
- Regulators, with an example being active lobbying of the ASX to improve its listings rules to provide greater shareholder protection for minority shareholders ([A Case Study in Poor Capital Allocation: The Need for Greater Shareholder Protections](#)) and [Divestments & Shareholder Rights](#));
- Investment banks and other advisors, including proxy and governance firms; and
- The media by providing public commentary or background material with the purpose of influencing better corporate governance.

Private vs Public Engagement

Our engagement will almost always be held privately, through emails, letters, face-to-face meetings, teleconferences etc. However, there are instances where we publicly express concerns if we feel it is in the best interests of shareholders and hence our investors. This has typically been in relation to critical issues (e.g. divestments, takeover approaches etc.) where we felt our concerns were not being adequately addressed and / or where we would like to garner the support of other investors.

Case studies highlighting our strong engagement track record are outlined in Appendix 2.

Engagement and ESG

We have a strong commitment to engaging on ESG issues. We seek to engage regularly with the management teams and boards of companies with the objective of better understanding their position and share ours on key ESG issues. We also believe it is important to assist them in understanding how we think about ESG in our investment process and how this can drive the sustainability of cashflow and mitigate downside scenarios into the future.

We incorporate environmental, social and governance (ESG) considerations into our assessment of sustainable free-cash-flow and in arriving at Conviction Scores. This means we are less likely to invest in companies if the market is complacent about ESG risks that we see as significant.

As part of this process and where relevant, we engage with management teams and boards of companies to understand their positions on key ESG issues and to influence or change their view where ours differs. We also believe it is important to assist companies in

We engage privately but are prepared to go public if necessary

We engage with companies on a broad spectrum of key issues

understanding how we think about the linkages between ESG related matters, sustainable free-cash-flow and the resultant the valuation of their businesses.

As part of our commitment to active ownership, Merlon is a signatory to the Principles for Responsible Investment (PRI). The PRI is the overarching framework of our ESG approach and we commit to the following:

- We will incorporate ESG issues into our investment analysis and decision-making processes;
- We will be active owners and incorporate ESG issues into our ownership policies and practices;
- We will seek appropriate disclosure on ESG issues from entities in which we invest;
- We will promote acceptance and implementation of the PRI within the investment industry;
- We will work to enhance our effectiveness in implementing the PRI; and
- We will report on our activities and progress towards implementing the PRI.

Our commitment to the PRI Principle to be active owners is demonstrated through our engagement activities across our portfolio of investee companies. A sample of the specific ESG issues we might raise with companies is outlined in Table 2:

Table 2: Sample of specific ESG issues that may be raised with companies

<i>Environmental</i>	<ul style="list-style-type: none"> • Impact of climate change including physical and transition risks • Recycling • Packaging • Water • Site remediation
<i>Social</i>	<ul style="list-style-type: none"> • Modern Slavery • Workplace health and safety • Supply chain management • Human rights • Employee recruitment and retention • Treatment of customers • Treatment of staff • Customer satisfaction
<i>Governance</i>	<ul style="list-style-type: none"> • Board structure • Capital allocation • Related party transactions • Remuneration structure • Accounting practices • Alignment with shareholders

Source: Merlon

Responsibility for Engagement

Within the investment team, we have a senior investment professional with overall responsibility for coordinating engagement activities and ensuring a consistent approach. The senior portfolio managers have ultimate responsibility for voting decisions. However, our general approach is to provide a high degree of autonomy, accountability and responsibility to responsible analysts.

As an owner-managed firm with significant co-investment alongside our clients, the investment team have a strong alignment with clients on engagement matters.

Tracking Engagement Activity

We keep a notes and records of company and other engagements and draw on these for future engagements and monitoring. We maintain proprietary qualitative scores, financial models and Conviction Scores on companies in our investible universe including scores specific to management and governance. These scores and models may be influenced by our engagement activities which in turn impact portfolio investment decisions.

Engagement activities are tracked and reported to our investors and the PRI annually. We have a weekly investment meeting to coordinate our engagement activity and resolve contentious issues.

Conflicts of Interest

In accordance with regulatory requirements, Merlon maintains a conflict of interest policy to ensure that any actual, potential and/or perceived conflict of interest that may arise both between itself and its clients, a staff member and a client and between clients are identified, prevented or managed and disclosed in the best interests of clients.

All Merlon staff are required to complete annual conflicts of interest training to ensure they have the appropriate understanding to identify and report conflicts of interest which can then be prevented or managed pursuant to its conflicts of interest framework.

Appendix 2: Engagement Case Studies

Case Study 1: AMP's Life Insurance Sale

Governance issue: Poor capital allocation

On 25 October 2018, AMP announced the sale of its Australian and New Zealand wealth protection and mature businesses (AMP Life) for A\$3.3b to Resolution Life. We believed the sale represented a destruction of shareholder value, as evidenced by the 28% decline in the share price in the two days following the announcement. Our engagement with the company was as follows:

Table 3: AMP engagement

Dates	Actions
25 October 2018	<ul style="list-style-type: none"> Initial discussions with management Discussions with other shareholders
27 October 2018	<ul style="list-style-type: none"> Letter to the board on detailing our position and concerns
October 2018 to April 2019	<ul style="list-style-type: none"> Contribution to various media articles in The Australian and Australian Financial Review as well as appearing on ABC Business several times
31 October 2018	<ul style="list-style-type: none"> AMP releases additional information in relation to the AMP portfolio review to respond to Merlon requests
1 November 2018	<ul style="list-style-type: none"> Follow-up letter to board in response to additional information released
15 November 2018	<ul style="list-style-type: none"> We highlight AMP experienced the worst share price reaction of all top 100 company divestments since 2000 and that never before has a top 100 company sought to divest so much of its operations without shareholder approval (Divestments & Shareholder Rights)
31 March 2019	<ul style="list-style-type: none"> We highlighted the need for greater shareholder protections on 31 March 2019 (A Case Study in Poor Capital Allocation: The Need for Greater Shareholders Protections)
12 April 2019	<ul style="list-style-type: none"> We actively campaign for the removal of AMP chair for governance failings ahead of the AGM (ABC Business) and meet with all key proxy advisors to share our views.
30 July 2019	<ul style="list-style-type: none"> We further detail the value of AMP on 30 July 2019 (The AMP valuation case)
1 July 2020	<ul style="list-style-type: none"> AMP announces the completion of the sale on 1 July 2020 and return of capital to shareholders

Source: Merlon

Case Study 2: Boral's acquisition of Headwaters

Governance issue: Poor capital allocation

On 21 November 2016, Boral announced the acquisition of Headwaters Incorporated – a US listed company - for US\$24.25 per share or A\$3.7b in total. The acquisition was funded by a mixture of debt and a \$2.1b capital raising.

Table 4: Boral engagement

Dates	Actions
1 December 2016	<ul style="list-style-type: none"> Met with management and expressed concerns over price paid
31 December 2016	<ul style="list-style-type: none"> We released a report detailing our views (Boral's High Price Acquisition of Headwaters Incorporated). We considered Boral to have overpaid by between 10% and 40%
2 August 2017	<ul style="list-style-type: none"> Met with members of the board to understand the process for making the acquisition including due diligence done
June 2017 to September 2017	<ul style="list-style-type: none"> Exited investment after holding for four years once the stock recovered to ~\$7
December 2018 to June 2019	<ul style="list-style-type: none"> Reacquired a position when the stock represented better value
27 August 2019	<ul style="list-style-type: none"> Meeting with management following FY19 result. Sought an understanding from management regarding the underlying organic growth of the North American business. The base business had been deteriorating, reflecting too much emphasis on deal synergies
1 November 2019	<ul style="list-style-type: none"> Sought accountability from the Chairman Kathryn Fagg in pre-AGM call
10 February 2020	<ul style="list-style-type: none"> Boral announces retirement of CEO Mike Kane
15 June 2020	<ul style="list-style-type: none"> Boral announces new CEO Zlatko Todorovski.
28 August 2020	<ul style="list-style-type: none"> Headwaters deal failings are detailed in the FY20 result presentation. The company writes down the value of their investment in Headwaters by \$1.1b
28 September 2020	<ul style="list-style-type: none"> Boral announces significant board renewal. Only the Chairman and one other director remain from the time of the Headwaters deal
13 October 2020	<ul style="list-style-type: none"> Pre-AGM call with the Chairman Kathryn Fagg and retiring Director John Marlay
15 October 2020	<ul style="list-style-type: none"> Chairman indicates she will retire in 2021

Source: Merlon

Case Study 3: Caltex's takeover approach

Governance issue: Not acting in shareholder's interests

On 28 November 2019, Caltex announced the receipt of a non-binding, indicative and conditional proposal from Alimentation Couche-Tard for \$34.50 per share in cash. This followed an earlier proposal in October for \$32 per share that was not disclosed. On 3 December 2019, Caltex announced that the Board had concluded that the proposal undervalued the company but offered to provide Alimentation Couche-Tard with selected non-public information to allow it to submit a revised proposal.

Table 5: Caltex engagement

Dates	Actions
28 November 2019	<ul style="list-style-type: none"> Initial discussions with management once the takeover approach had been confirmed
4 December 2019	<ul style="list-style-type: none"> Formal letter and presentation sent to the board detailing our views. We disagreed with the board's view that the offer undervalued Caltex
5 December 2019	<ul style="list-style-type: none"> Meeting with Chairman
6 December 2019	<ul style="list-style-type: none"> Merlon issues clarification regarding our position on 6 December 2019 (Merlon Clarifies its Position Regarding Couche-Tard Offer for Caltex Australia)
December 2019	<ul style="list-style-type: none"> Contribution to various media articles in The Australian and Australian Financial Review
17 December 2019	<ul style="list-style-type: none"> Follow-up letter on 17 December to the board with follow-ups from prior meeting
13 February 2020	<ul style="list-style-type: none"> Alimentation Couche-Tard boosts offer
20 April 2020	<ul style="list-style-type: none"> Alimentation Couche-Tard walks away from bid

Source: Merlon

Some other examples

Some other examples include formally engaging with the chair of Wotif in July 2014 and ilNet in March 2015 to express our disappointment and urge the rejection of the low takeover offers from Expedia and TPG Telecom respectively; the chair of Seven West Media in April 2015 in relation to convertible preference shares that diluted the value of ordinary shares; and more recently publicly shared our disapproval of the Amaysim board's support of the low takeover offer from Optus ([The Strategic Value of Amaysim](#)).

Neil Margolis



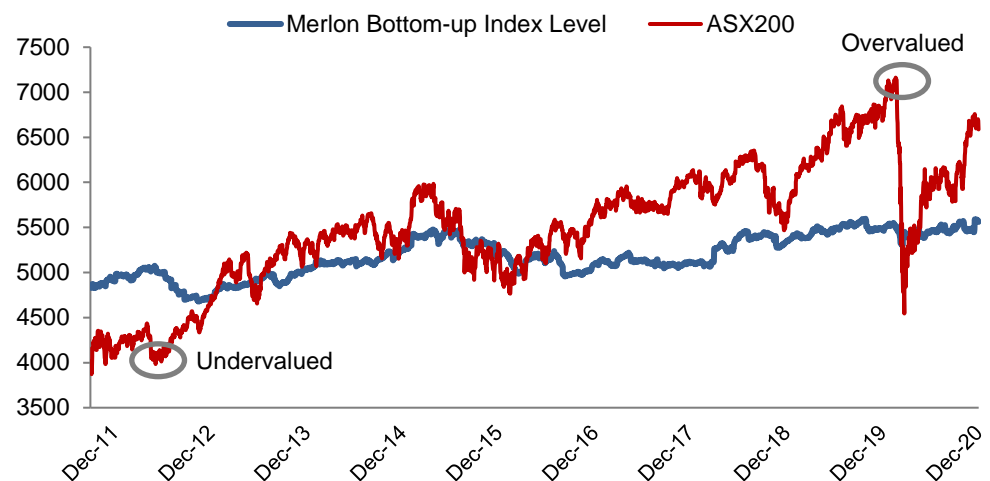
Market approximately 18% undervalued using consistent bottom-up approach...

Confidence indicators and markets are leading economic activity ...

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 158 stocks we actively cover. On this basis the market appears approximately 18% overvalued after rallying strongly during the quarter.

Figure 8: 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 prior updates and in our [March 2020 COVID Roadmap](#) we were optimistic that at some point there would be a vaccine, herd immunity will develop, and ordinary life will bounce back. It is not surprising to us therefore that the market accumulation index is within 5% of its all-time high although record low rates have continued to manifest in very wide valuation dispersion between sectors and stocks.

2021 will feature the incoming Biden administration, coupled with an accelerated global COVID-19 vaccine rollout, both of which are serving to boost confidence, seen most directly in US ISM Manufacturing PMI. Should this prove to be a reliable indicator of the economic

recovery, we can expect upward pressure on bond yields (see chart below), perhaps presaging an environment more favourable for value-based investing.

Figure 9: US 10 Year Treasury Yields

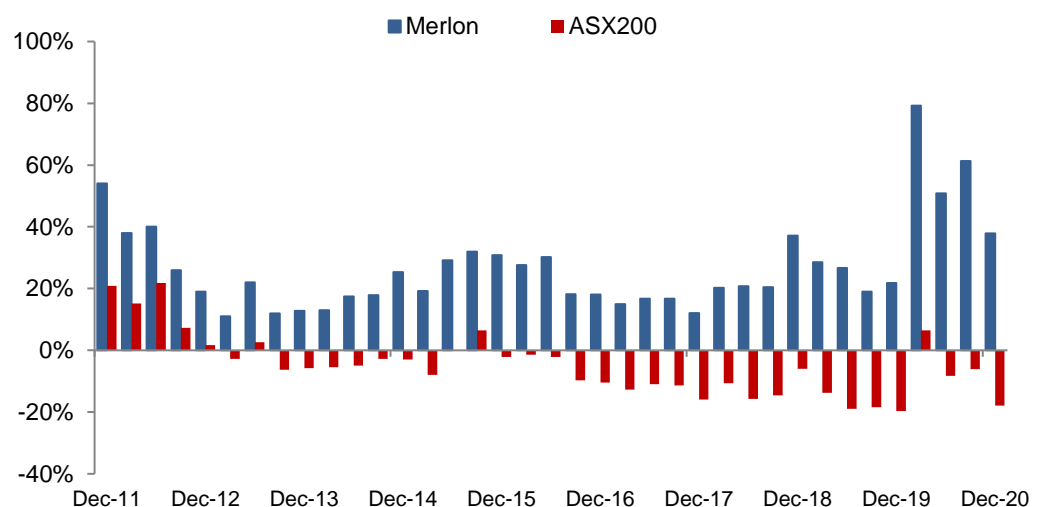


Data source: Federal Reserve Bank of St. Louis. Calculations / analysis: Merlon Capital.

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.

Figure 10: Expected return based on Merlon valuations



Source: Merlon

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

.. with bond yields poised to follow suit

The risk of permanent loss is mitigated by owning undervalued assets

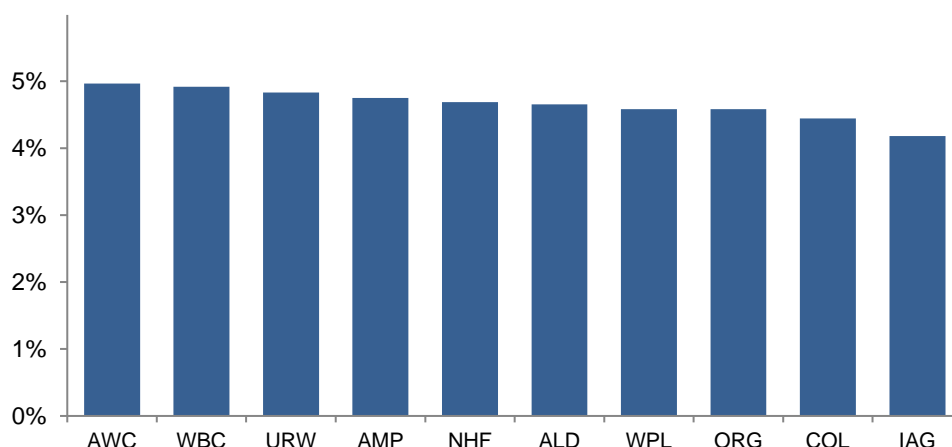
The Merlon portfolio continues to offer truly exceptional expected returns...

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 11: 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.

Alumina Limited was established during the second half of 2020, with COVID-19 related market concerns providing attractive entry points for investment. The stock has been impacted by the effect of COVID-19 on transport and an associated concern with demand for transport materials, such as aluminium. The market is also concerned by continued growth in Chinese alumina refining capacity, enabled by China’s development of extensive bauxite reserves in Guinea. Yet we see Alumina Limited’s competitive low-cost position to enable it to prevail relative to higher cost peers, should China’s growth require any market rationalisation.

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.

After establishing an initial position during the COVID downturn and adding at lower levels, **Unibail-Rodamco-Westfield** has rallied to become a large position. The stock has been impacted by the effect of COVID-19 lockdowns across Europe and US, where its portfolio of high-grade shopping malls are located. The market is also concerned by the threat of online consumer purchasing behaviour, a concern also exacerbated by COVID-19. We expect the value of its premium-grade portfolio to be reflected by the market as the rollout of the vaccine gathers pace, particularly given the backdrop of negative real interest rates.

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.

The health insurer, **NIB Limited** was also established in the second half of 2020, with the market concerned about declining participation rates and regulatory risks relating to government subsidies. Yet we believe the industry is sustainable as it essentially administers a Government scheme, while political support for private funding of health care is likely to remain. We also expect the company’s loss-making student and travel insurance businesses to return to profitability in a post-COVID environment.

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.

Woodside has been cheap as a result of low oil prices, which impact the pricing of the company’s LNG export volumes. Yet we expect oil prices to recover as demand recovers to

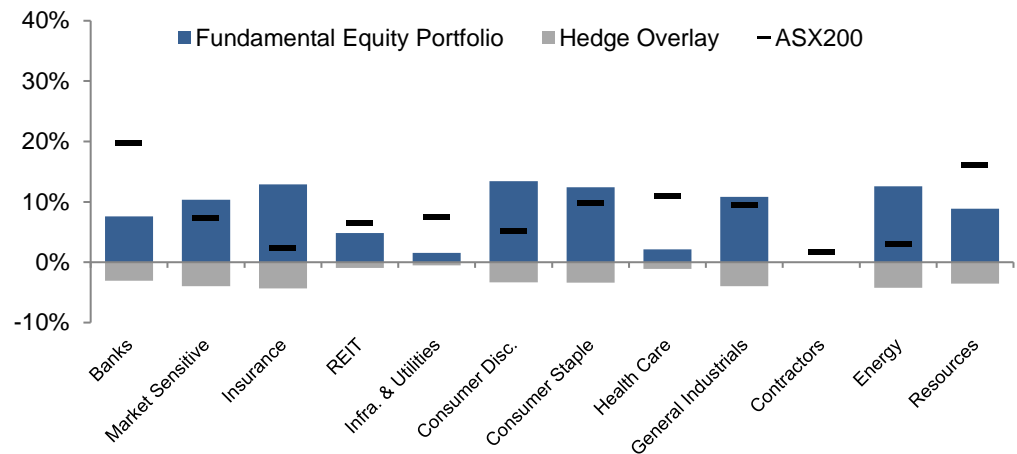
pre-COVID levels, and the underinvestment in conventional and now unconventional oil manifests in a reduced ability of supply to meet demand.

Origin Energy is also cheap due to low oil prices. In addition, the market is also concerned by the effect of low electricity pricing on Origin's wholesale and retail electricity businesses. Yet low electricity prices have been mostly driven by low coal and gas prices, more so than the growth in renewables supply, and should recover to more normal levels as these commodities continue to recover.

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 still generating margins below historic levels despite the COVID demand boost.

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.

Figure 12: Portfolio exposures by sector (gross weights)



Source: Merlon

Figure 13: 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
Mid-cycle 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 were three new investments in the quarter and three positions exited

December Quarter Portfolio Activity

During the quarter, we established new investments in **Incitec Pivot** and **G8 Education**, and re-invested in **Bendigo Bank**, all of which had become overly cheap due to COVID-related issues.

Incitec Pivot is Australia's leading fertilisers distributor and is a top-two global explosives manufacturer / distributor. The investment opportunity was presented by the market's over-emphasis on the short-term risks in COVID-driven declines in activity levels, coupled with continued concerns regarding drought. Downside risk is mitigated by its dominant market positions in both explosives and fertilisers, and an increasing focus on capital-light growth strategies.

G8 Education is Australia's largest for-profit childcare provider, currently turning around their portfolio of centres. The market has reduced confidence management will be successful as the stock is currently trading as if more than 20% of centres will be closed. However, we are encouraged by management's successful sale of the underperforming Western Australian sites and distracting Singaporean sites. We are also encouraged by the bipartisan industry support revealed by COVID-19 policy settings, and the capital raising de-risking the balance sheet.

As mentioned in the portfolio outlook, the opportunity to add to banks arose because their share prices lagged industrials in the recovery, yet recession tail risks receded with virus suppression, improved activity and record stimulus.

We also added to existing positions in **Origin Energy**, **Woodside Petroleum**, and **IOOF Limited**.

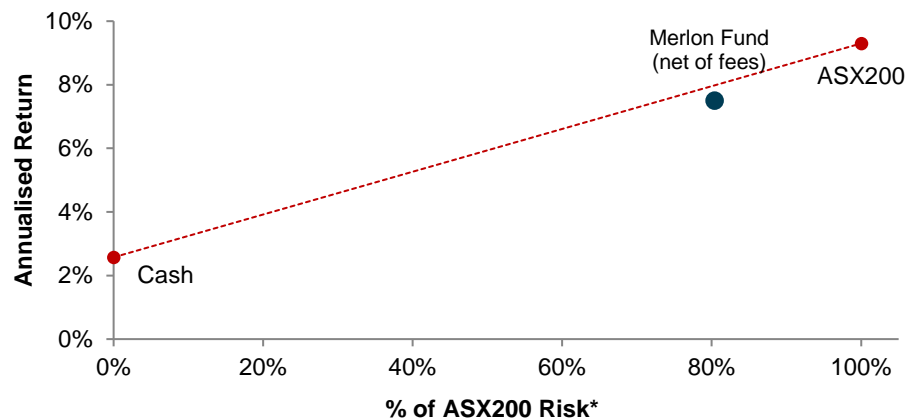
These positions were funded by exiting positions in **Fletcher Building**, **Boral** and **Ooh!Media**, which had rallied beyond our fundamental valuations through the year.

Performance ⁱ (%) (after fees, inc. franking)	Month	Quarter	FYTD	Year	3 Years (p.a.)	5 Years (p.a.)	7 Years (p.a.)	10 Years (p.a.)
Fund Total Return	-0.0	14.9	11.2	0.0	3.0	6.9	6.4	7.5
70% ASX200 / 30% Bank Bills	0.9	9.5	9.6	2.7	6.4	7.8	6.9	7.5
ASX200	1.2	13.8	13.7	2.3	8.0	10.1	8.8	9.3
Average Daily Exposure	64%	65%	64%	66%	68%	68%	68%	69%
Gross Distribution Yield	0.4	1.5	3.2	6.4	7.0	7.3	7.4	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, 31 December 2020.

Figure 14: Rolling Ten Year Risk vs. Return (%p.a.)ⁱⁱ



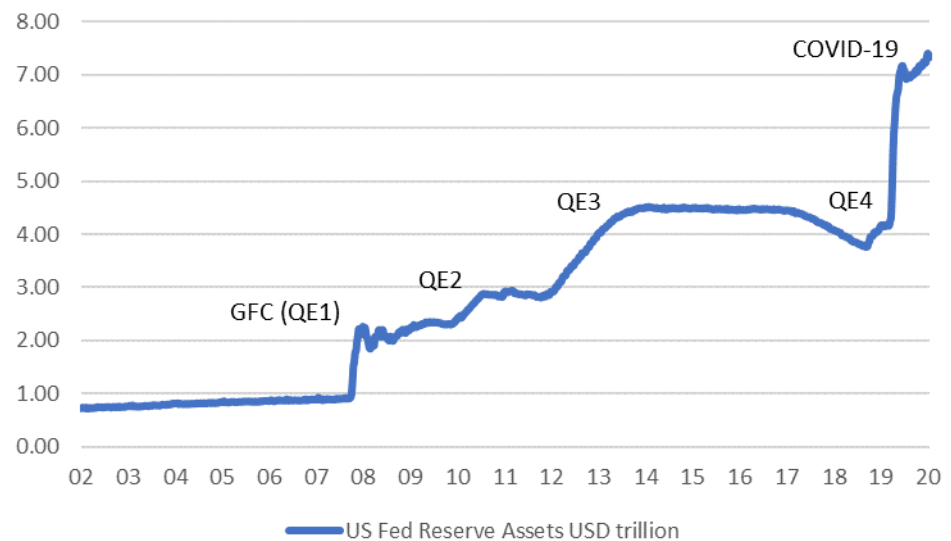
Source: Merlon

December Quarter Market & Portfolio Review

Global markets rallied strongly during the quarter on the announcement of successful COVID-19 vaccine trials, ongoing record stimulus and continued signs of a positive economic outlook. Central Banks (including Australia's Reserve Bank) continued to support economies via aggressive quantitative easing programs, albeit with gold remaining flat over the quarter, as US treasury yields continued to rally, ending the quarter at 93 basis points, up from 69 basis points – continuing to support the theory that yields may have peaked and seem set to continue rising as economies recover.

Markets continued recovering strongly during the quarter

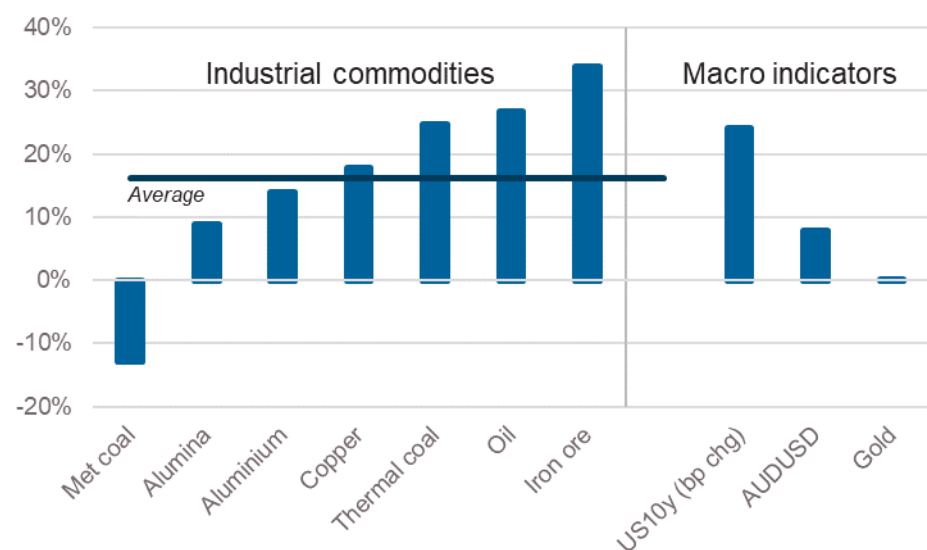
Figure 15: US Federal Reserve Total Assets



Data source: Federal Reserve Bank of St. Louis. Calculations / analysis: Merlon Capital.

Not surprisingly we saw a broad-based commodity rally as successful vaccine trials saw investors / speculators direct capital into industrial commodities on increased confidence of a post-COVID demand recovery. Energy, in the form of oil and thermal coal both performed strongly, while iron ore benefited from China's closed capital account, which forces its large domestic capital base to choose from a relatively limited suite of potential investments (domestic equities, bonds, property or iron ore futures, representing the largest such opportunities).

Figure 16: Quarterly commodity price returns vs key macro indicators



Data source: Bloomberg. Calculations / analysis: Merlon Capital.

In addition to **Materials** outperforming, **Banks** were the best performing sector, playing catch-up to other cyclicals as the recovery continued and downside economic risks receded.

Stock level contributors in the quarter were broad-based

Discretionary sectors such as **Media** also performed strongly while the **Technology** outperformance showed no signs of slowing. Defensive sectors such as **Healthcare**, **Utilities** and **Consumer Staples** lagged as investors rotated into more cyclical stocks.

Against this backdrop the portfolio increased by **14.9%** in the quarter (net of fees and including franking), outperforming the market by **1.1%**. Being non-benchmark was a modest tailwind, with the average company outperforming the cap weighted index by 0.4% despite the major bank rally. Pleasingly, contributions to this outperformance was varied, with **Unibail-Rodamco** (Real Estate Investment Trust), **Sims Metals** (General Industrials), **NIB Holdings** (Insurance), **Southern Cross Media** (Media), and **Janus Henderson** (Financials) the top five performers, in addition to not holding **CSL**. Despite gold ending the quarter only 5% below all-time highs, **Newcrest** detracted, as equity investors sought to move ahead of a potential tapering of monetary policy. Other detractors within the portfolio included **QBE Insurance**, on an earnings downgrade and reserve increases and **Super Retail Group**, seen as laggard when travel resumes. Stocks not held that detracted include the major banks, **CBA**, **ANZ** and **National Australia Bank**, iron ore producers **BHP** and **Fortescue Metals**, and **Afterpay**.

Given the strong returns from the share portfolio the hedge overlay was a headwind, detracting

Financial year-to-date, the Fund has underperformed by **2.5%**, with the hedge overlay detracting given the strong returns from the underlying share portfolio. The underlying share portfolio has outperformed by **3.8%**. Key contributors included **Newscorp**, **Sims Metal**, consumer names **Harvey Norman**, **Star Entertainment Group** and **Super Retail**, as well as not holding **CSL**. Detractors included **AMP**, with capital returns on hold during the portfolio review and the life sale being finalised on the last day of the prior financial year, **Insurance Australia Group**, announcing large business interruption provisions, **Origin Energy** and **Newcrest**, as oil and gold prices plateaued, and not owning **Fortescue Metals**.

During the 2020 calendar year, the portfolio underperformed by **1.3%**. It felt like four years in one, with each quarter presenting something unique and challenging. Growth stocks represented within the Healthcare and Technology sectors that are not held by virtue of our investment philosophy detracted 1.9% during 2020.

Key contributors from stocks held over the 12 months included defensive cash-generative names held prior to COVID, being **Coles** and **A2 Milk**, investing in cyclicals near their COVID lows such as **Star Entertainment Group** and **oOh!media**, and retaining conviction in consumer discretionary market leaders **Harvey Norman**, **Nick Scali**, and **Newscorp**. **Boral** and fund manager, **Janus Henderson**, rounded out the top 10 contributors.

Key detractors over the year included oil producers held prior to COVID, **Origin Energy** and **Woodside**; **IOOF**, with what appeared to be a full-priced MLC acquisition and large capital raising; general insurers, **QBE** and **Insurance Australia**, on business interruption claims

The portfolio underperformed during 2020 but recovered strongly after the March downturn

and capital raisings; and not owing **Afterpay** and iron ore miners, **Fortescue Metals**, **Rio Tinto**, and **BHP**. Rounding out the largest detractors were **Flight Centre** and **Southern Cross Media**, both of which recovered but not fully given the extent of new shares issued to repay debt.

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 40.

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	17.5	-9.3	8.4	7.4	23.5	7.0	9.5	16.3	36.0	-3.4	10.4
Hedge Overlay	-5.8	3.9	-0.9	-2.3	-5.6	-0.9	-1.7	-3.5	-9.3	2.6	-1.9
Fund Return (before fees)	11.7	-5.4	7.5	5.1	17.9	6.1	7.8	12.8	26.7	-0.8	8.5
Fund Return (after fees)	11.2	-6.3	6.5	4.1	16.8	5.1	6.8	11.8	25.6	-1.8	7.5

FY Performanceⁱ (%) (before fees, inc. franking)	21TD	2020	2019	2018	2017	2016	2015	2014	2013	2012	10 Years (p.a.)
Underlying Share Portfolio	17.5	-9.3	8.4	7.4	23.5	7.0	9.5	16.3	36.0	-3.4	10.4
ASX200	13.7	-6.5	13.2	14.5	15.5	2.2	7.2	18.9	24.3	-5.1	9.3
Excess Return	3.8	-2.8	-4.8	-7.1	8.0	4.8	2.3	-2.7	11.7	1.7	1.1

FY Performanceⁱ (%) (after fees)	21TD	2020	2019	2018	2017	2016	2015	2014	2013	2012	10 Years (p.a.)
Income	3.2	5.2	5.8	5.5	6.2	5.9	5.6	5.8	7.8	7.6	8.4
Franking	0.7	1.2	2.2	1.5	1.6	2.1	1.9	1.7	2.3	2.5	2.0
Growth	7.3	-12.7	-1.4	-2.8	9.0	-2.9	-0.7	4.3	15.5	-11.9	-2.9
Fund Return (after fees)	11.2	-6.3	6.5	5.1	16.8	5.1	6.8	11.8	25.6	-1.7	7.5

FY Performanceⁱ (%) (after fees, inc. franking)	21TD	2020	2019	2018	2017	2016	2015	2014	2013	2012	10 Years (p.a.)
Fund Return (before fees)	11.7	-5.4	7.5	5.1	17.9	6.1	7.8	12.8	26.7	-0.8	8.5
70% ASX200/30% Bank Bills	9.6	-3.6	9.9	10.6	11.3	2.2	6.0	14.0	17.8	-2.1	7.5
Excess Return (before fees)	2.1	-1.9	-2.4	-4.4	6.6	3.9	1.8	-1.2	8.9	1.3	1.0
Excess Return (after fees)	1.6	-2.7	-3.4	-5.4	5.5	2.9	0.8	-2.2	7.7	0.4	0.0

Monthly Distribution Detail: Cents per Unit

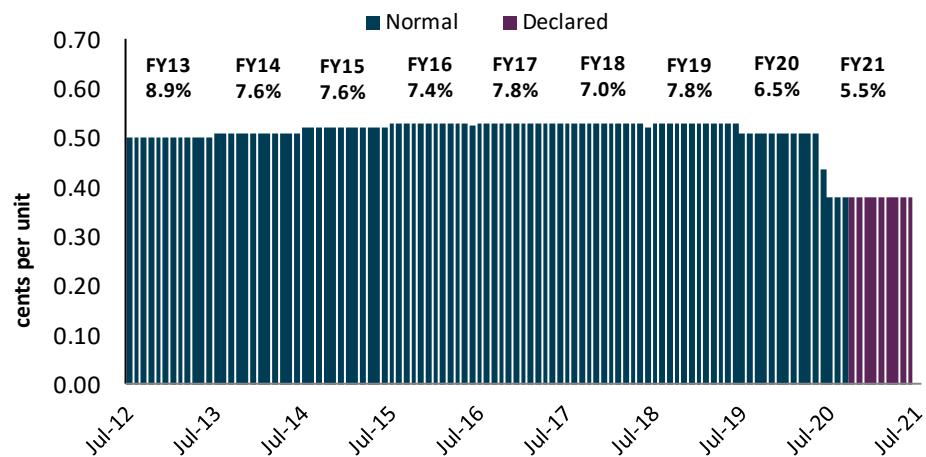
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Total	Franking
FY2013	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.29	6.79	2.26
FY2014	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.52	6.13	1.98
FY2015	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	6.24	2.20
FY2016	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 17: 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

[The Strategic Value of amaysim](#)

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

[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	\$ 483m	Merlon FUM	\$ 918m
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 December 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 0.0%, Qtr 0.2%, FYTD 0.7%, 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 0.0%, Qtr 0.1%, FYTD 0.5%, Year 0.9%, 3 Years 1.3% p.a., 5 Years 1.4% p.a., 7 Years 1.4% p.a., 10 Years 1.5% p.a.

[^] Source: Fidante Partners Limited, 31 December 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.