

# Merlon Concentrated Australian Share Strategy

Monthly Update – February 2024



## Strategy Features

**Proven Investment Philosophy:** We believe people are motivated by short-term outcomes, overemphasise recent information and are uncomfortable having unpopular views.

**Simple Process:** We invest in undervalued companies where we think market participants have become too pessimistic.

**Concentrated:** A portfolio of 25-35 companies constructed without regard to benchmark weights.

**True-to-Label Performance:** Merlon's investment team has a proven long-term value investing track record since its 2010 inception.

**Integrated ESG Approach:** We believe deep consideration of governance, social as well as environmental issues – coupled with active ownership – enhances investment, business and community outcomes.

## Strategy Performance gross of fees

% <sup>1</sup>	Fund	Benchmark <sup>2</sup>	Excess
<b>Since Inception (p.a)<sup>3</sup></b>	11.9	10.0	1.9
<b>10 Years (p.a)</b>	11.1	9.4	1.7
<b>5 Years (p.a)</b>	12.3	9.9	2.4
<b>3 Years (p.a)</b>	16.9	10.7	6.2
<b>1 Year</b>	15.6	12.1	3.5
<b>CYTD</b>	7.8	2.2	5.6
<b>Quarter</b>	14.5	9.6	4.9
<b>1 Month</b>	3.9	1.0	2.9

<sup>1</sup>Performance figures are calculated before fees have been deducted and assume distributions have been reinvested. All returns are grossed up to include franking credits. No allowance is made for tax when calculating these figures. Past performance is not a reliable indicator of future performance.

<sup>2</sup>The Fund benchmark is the S&P/ASX 200 Accumulation Index (inclusive of franking credits)

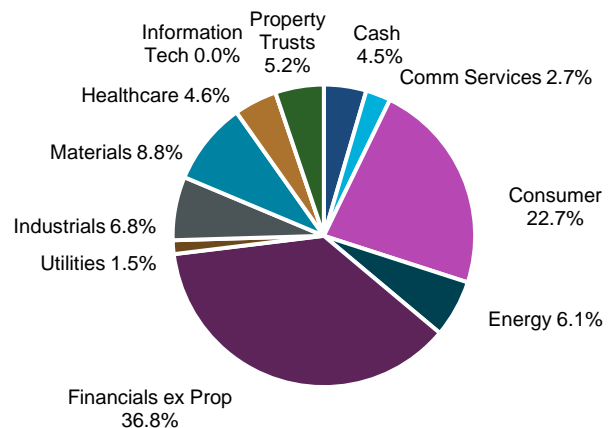
<sup>3</sup>The Strategy Inception date is 31 May 2010.

Source: Fidante Partners Limited, 29 February 2024.

## Strategy Facts

<b>Portfolio managers</b>	Neil Margolis
<b>Fund inception date</b>	31 <sup>st</sup> May 2010
<b>Merlon FUM</b>	\$785m
<b>Strategy FUM</b>	\$137m
<b>Fund FUM</b>	\$137m

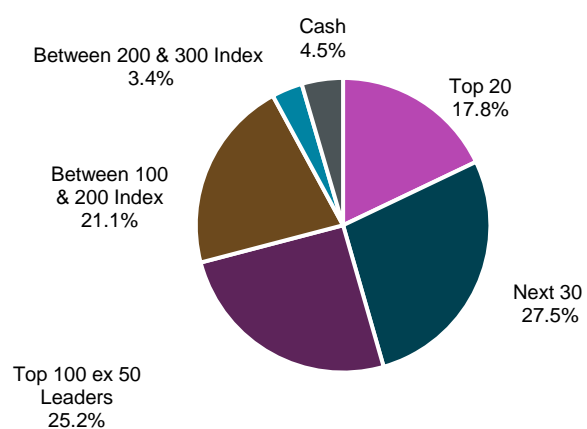
## Sector Exposure



## Top 10 Holdings (Alphabetical)

a2 Milk Co	CSR
Alumina	Fletcher Building
AMP	Insurance Australia Group
ASX	QBE Insurance Group
Coles	Westpac Banking Corporation

## Market Cap Bands - Fund



### Monthly update

Global markets continued their move upwards in February, and while the ASX200 lagged the wider market, it still delivered a positive return of 0.8%. All eyes appeared to be on reporting season and the focus of the market on fundamentals seemed to mute the response to rising yields and the market pushing out interest rate cuts in 2024. While this certainly isn't the end of macro factors impacting returns, with uncertainty across inflation, interest rates and geopolitics remaining elevated, however for bottom-up managers it is refreshing to see the market be disciplined in its treatment of fundamental company performance.

As mentioned, February's focus was on reporting season, and this drove the performance across the market and indeed impacted the sectoral performance. During the month IT, Consumer Discretionary and REITs drove the market performance, while Energy, Materials and Healthcare underperformed. Overall earnings were in line with expectations across reporting season despite an average 1% downgrade across the period.

Merlon continued its strong performance in January by delivering 3.8% performance (gross of fees and franking) which was 3.0% ahead of the wider market. Pleasingly the longer-term numbers also remain strong and display Merlon's resilience across the recent cycle. The largest contributors to performance were CSR, A2M, AMP, while not holding BHP and CSL also contributed strongly. Not holding WES and GMG detracted, while positions in AWC and HLS also impacted performance. Interestingly, Merlon held CSR and AWC who both benefited from takeover bids, which exhibits the underlying fundamental value that Merlon has discussed in detail with both Boards in recent times.

### Market outlook and positioning

As has been the case for nearly two years now, the Merlon assessment remains that the market appears overvalued. Interestingly, we have discussed in previous months the conviction the market has in an imminent easing cycle, but despite an increase in yields and these expectations being pushed out, the market continued to rise, driven by the strength of the economic outlook and quite specifically technology. The Merlon market valuation, which reflects Merlon's bottom-up assessment of long-term cash-flow, discounted at mid-cycle discount rates continues to show that while the market looks 13% overvalued, the portfolio continues to show an estimated upside of 25%. This buffer between the overvalued market and the dispersion for the portfolio, provides the opportunity for active management and excess returns.

As we have noted above, the resilience of the economy has continued, which in turn has pushed out the number of interest rate cuts expected in 2024. In recent years, any delay in the narrative of Central bank easing has been met with volatility. However, in the last few months the market has taken such news in its stride, as the strength of company fundamentals and the resilient consumer has buoyed market sentiment. While this may have occurred recently, we remain cognisant of the impacts of market disappointment and indeed the risks of a second wave of inflation, which has history has shown to be a valid consideration. Combining inflation with geopolitics and growth concerns in some of the largest economies, means we remain wary of 'Goldilocks' being achieved, and as always, we consider the bear case scenarios for any investment.

Merlon deliberately factors in long-term or 'normal' interest rates into our valuations, so any further uncertainty on interest rates does not impact how we value and rank companies, nor does it affect our estimates of what normal cashflows look like. This remains consistent with our long-standing investment policy and allows the team to look through much of the short-term noise and focus on the opportunities that are sustainable from a free cash flow perspective. As mentioned above, our focus on the bear case and downside takes into consideration the genuine risks that are prevalent for companies in the market, and even factoring this in, we continue to identify under-appreciated opportunities across sectors.

The Merlon portfolio comprises our best research ideas, based on our long-term sustainable cash-flow based valuations. Merlon continues to re-evaluate and trim stocks as they have outperformed, and the process guides the team to concentrated positioning in our best ideas. The normalisation of interest rates will take time to play out, and the conservative investment process employed by Merlon, combined with a consistent valuation method, means the portfolio remains appealing and positioned well for such an environment.