Merlon Australian Share Income Fund

Quarterly Report – June 2022

For queries, please call Investor Services on 13 51 53

Fund Features

Sustainable income: Paid monthly and majority franked. As the Fund's name suggests, sustainable above-market income is a targeted outcome of our investment approach and a key objective of the Fund.

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

Portfolio Diversification: The benchmark unaware approach to portfolio construction is a key structural feature, especially given the concentrated nature of the ASX200 index.

Downside protection: 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.

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.

Fund Facts

Portfolio managers	Neil Margolis
Fund inception date	30th September 2005
Merlon FUM	$970m
Strategy FUM	$523m
Fund FUM	$378m
Management fee	0.95% p.a
Performance fee	nil
Fund objective[5]	The Fund aims to provide a higher level of tax effective income with a lower level of risk than the S&P/ASX 200 Accumulation Index, whilst also aiming to outperform the benchmark on a total return basis over the medium to long term.
Minimum Investment	$10,000
Suggested timeframe	At least 5 years
Buy/Sell Spread	+0.20% / -0.20%
Distribution Frequency	Monthly
APIR Code / ASX Code	HBC0011AU / MLO02

Top 10 Holdings (Alphabetical)

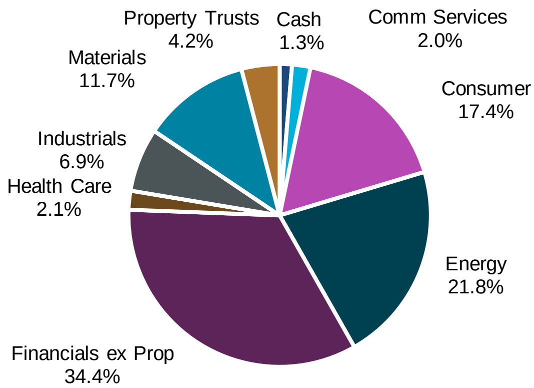
Alumina Limited	New Hope Corporation Ltd
AMP Limited	QBE Insurance Group Limited
Aurizon Holdings Ltd	Suncorp Group Ltd
Coles Group Ltd	Westpac Banking Corporation
IAG Limited	Woodside Petroleum Limited

Fund Performance net of all fees and expenses

%[1]	Fund	Benchmark[2]	Yield[4]
Since Inception[3]	6.8	6.8	9.6
10 years (p.a)	8.9	8.2	7.5
5 Years (p.a)	5.1	6.3	6.9
3 Years (p.a)	4.9	3.7	6.5
1 Year	5.5	-3.3	6.2
FYTD	5.5	-3.3	6.2
Quarter	-4.7	-8.3	1.3
1 Month	-5.6	-6.2	0.4

[1]Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. All returns are grossed up for franking credits. No allowance is made for tax when calculating these figures. Past performance is not a reliable indicator of future performance.
[2] The Fund's benchmark is a composite of 70% S&P/ASX 200 Accumulation Index / 30% Bloomberg Ausbond Bank Bill Index and is used for all time periods. From 30 September 2005 to 16 May 2022, the Fund's benchmark was the S&P/ASX 200 Accumulation Index.
[3]The Inception Date for the fund is 30 September 2005.
[4] Yield represents the Gross distribution yield (inclusive of franking credits)
[5]In line with the Fund's benchmark change, the Fund's objective was also amended on 16 May 2022 to include a total return objective.
Source: Fidante Partners Limited, 30 June 2022.

Sector Exposure



Quarterly value added relative to benchmark

Top 5	Value Added (%)
New Hope Corporation Ltd	0.9
Ampol Ltd	0.7
QBE Insurance Group Limited	0.7
Viva Energy Group Ltd	0.6
Aurizon Holdings Ltd	0.5

Bottom 5	Value Added (%)
Transurban Group Stapled	-0.4
Unibail Group Stapled	-0.5
Insignia Financial Ltd	-0.6
Alumina Limited	-0.7
CSL Limited	-0.7

Source: Fidante Partners Limited, 30 June 2022. Benchmark is S&P/ASX 200 Accumulation Index

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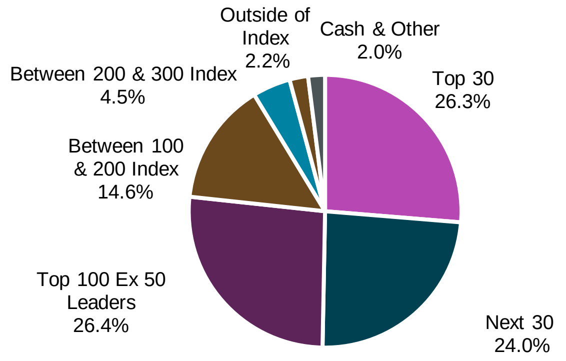
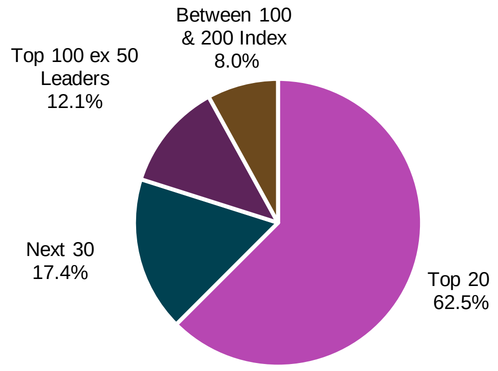
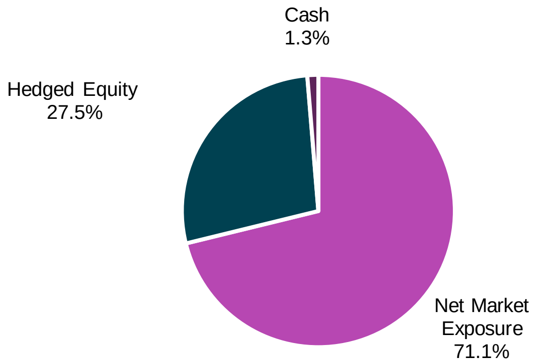
Market Cap Bands – Fund



Market Cap Bands – ASX 200



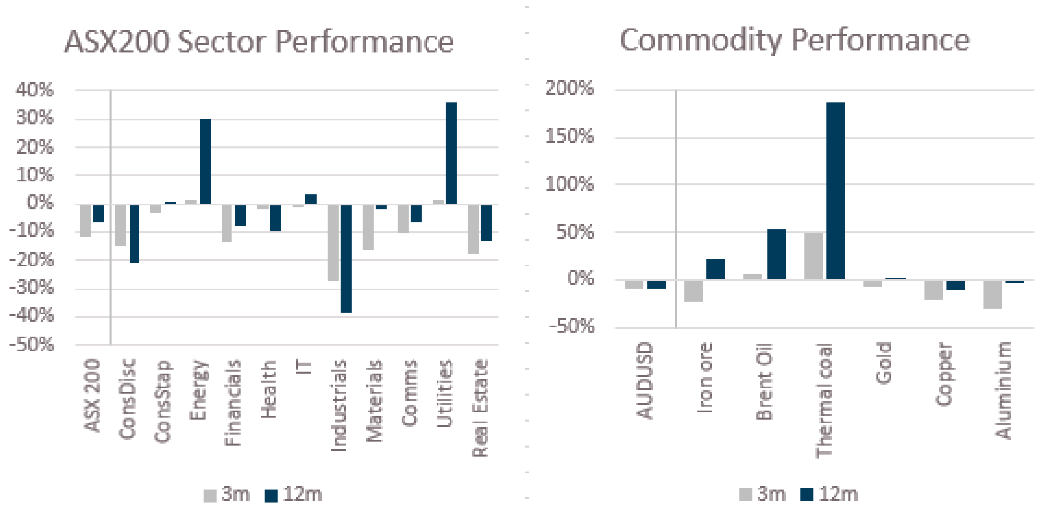
Asset Allocation



Market Review and Outlook

The Australian market shed 11.9% during the quarter, ending the financial year down 6.5%. All sectors were negative, with the exception the Energy and Utilities sectors, primarily a function of continued demand normalisation meeting the effect of several years of underinvestment. Russia's early 2022 invasion of Ukraine heightened energy market tensions.

Figure 1: Overview of key markets



Data source: Bloomberg, Merlon Capital.

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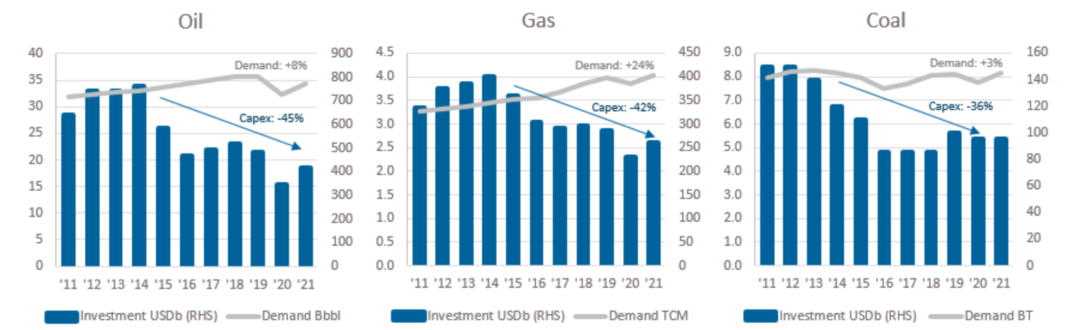
As inflation continued to rise and prove less transitory than expected – driven by supply constraints and spiking energy prices - central banks moved quickly to commence an aggressive tightening phase. This process seems likely to be more rapid than seen in recent cycles to combat inflation, while central banks are also cognizant that prior policy normalisation efforts fell short of targeted levels before cycles turned.

Markets are now firmly focused on the risks of recession, as COVID stimulus fades, while higher than expected inflation strangles purchasing power. We can see activity levels in the US and Europe falling relatively quickly, and into contractionary levels in the case of leading indicators such as manufacturing new orders.

Energy markets: As per previous reports, we saw energy prices continue to rise, a function of greater demand pulling on underinvested supply chains.

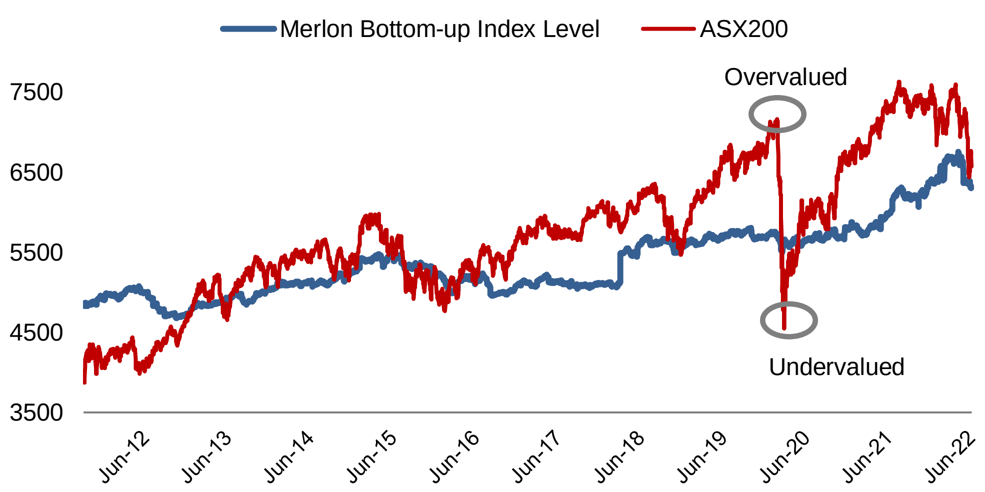
Figure 1a: System investment vs demand – global energy markets



Data source: International Energy Agency Calculations: Merlon Capital.

Russia's military activities in Ukraine continued beyond 100 days, emphasising the need for Europe to pivot towards new sources of traditional fuels as well as renewable energy systems. The pressure to continue to provide energy for their populations as well as continue to development renewable power, has seen the European Parliament support EU labelling gas as 'green' investment. While previously considered unlikely, Russia's invasion has seen priorities shift. Germany now seeks to reverse more than five decades of Russian energy dependency, reducing Russia's share of imports of gas from 55% to 10% by mid-2024. Again, this is increasing demand further on underinvested supply chains.

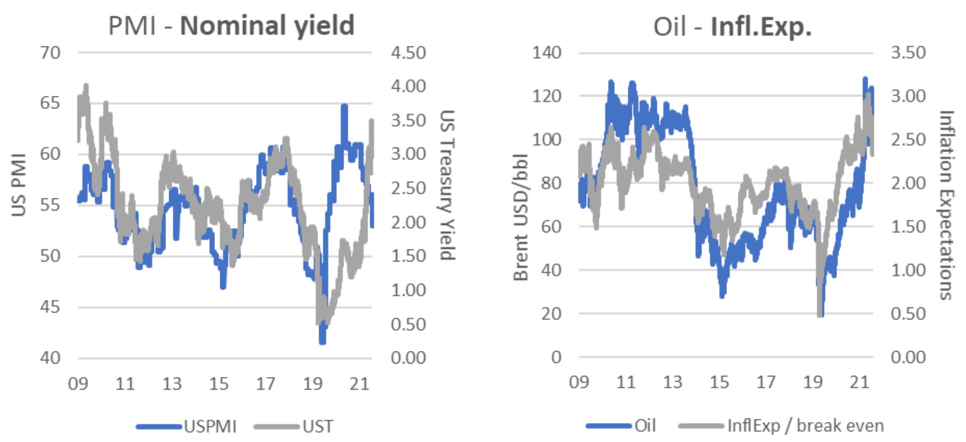
Figure 2: Merlon bottom-up market valuation vs ASX200 level



Source: Merlon

Having ground upwards from 1% to 2% over the course of 2021, US Treasury yields accelerated above 3% in less than 2 months in 2022. This spike came as the Fed removed its foot from the yield curve, having spent nearly USD5 trillion keeping it restrained while fiscal policy was allowed to stimulate the economy. Ironically it may be the economy that limits yields - at least in the near term - as the stimulus impulse fades and elevated energy prices and interest rates begin to curb economic activity. Yet even this effect may be fading, as inflation expectations have already begun to moderate, from above 3% in April, to 2.3% currently, as markets price in the contractionary impact of higher official rates and inflation itself.

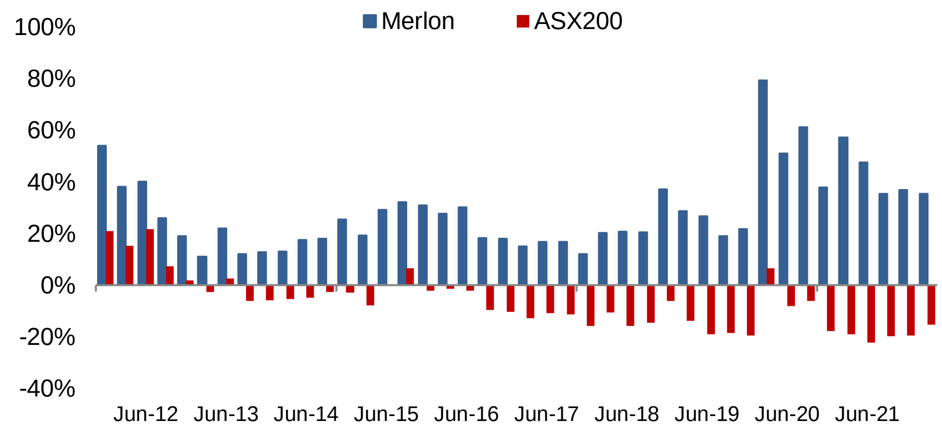
Figure 3: Yield, inflation, and policy



Sources: Federal Reserve of St. Louis. Institute of Supply Management. Bloomberg. Calculations: Merlon.

Merlon's focus on near-term cashflows rather than of long-dated growth potential may perform better in comparison to the broader market.

Figure 4: Expected return based on Merlon valuations



Source: Merlon

Portfolio Review

Last quarter we noted the apparent valuation discount across Australian energy companies. This quarter saw some of that valuation gap closed as investors began to see the tightness evident in these commodities.

Quarter: At a stock level, the key contributors to the portfolio during the quarter were overweight positions in Ampol and Viva Energy, New Hope Corporation, Aurizon and QBE Insurance. Partly offsetting these contributions were underweight positions in CSL and Transurban, and overweight positions in Alumina, Insignia Financial, and Unibail Group.

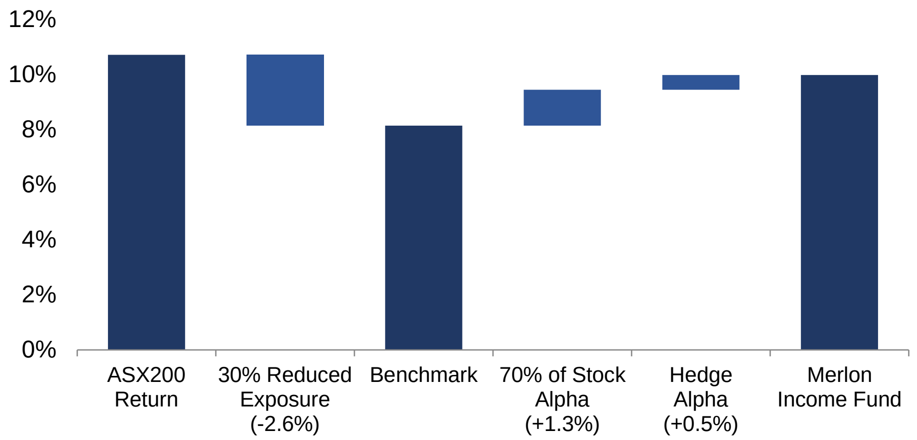
The risk reduction overlay contributed 3.1% during the quarter, insulating the Fund from part of falls in the underlying share portfolio.

Financial Year: The Portfolio also outperformed over the full financial year, driven by coal miners Whitehaven and New Hope, LNG producers Woodside and Origin Energy, and mid and downstream refiner marketer Ampol. Partly offsetting these contributions were underweight positions in BHP and overweight positions in Unibail Group, Insignia Financial, Super Cheap Retail and Southern Cross Media.

The risk reduction overlay provided a neutral return over the year, a pleasing result given the positive returns from the underlying share portfolio.

Over the last ten years the Fund has outperformed its benchmark with positive contribution from both the underlying share portfolio and the risk reduction overlay.

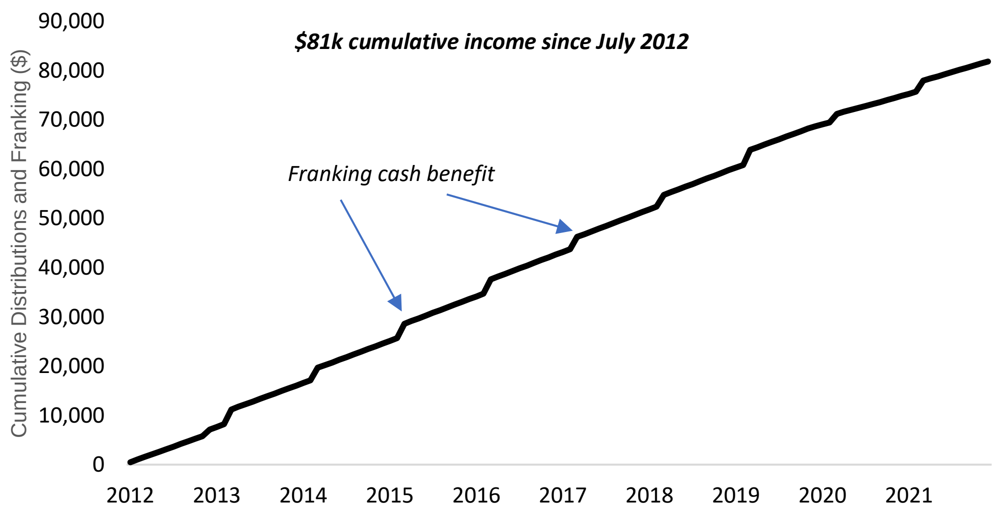
Figure 5: Drivers of performance – rolling ten years



Source: Merlon, returns stated before fees and inclusive of franking credits

The Fund also aims to provide a gross yield above the market, with distributions paid monthly. Over the last ten years the Fund's gross yield of 7.6%, or 1.7% above the ASX200. The below chart highlights the cumulative income from $100,000 invested on 1 July 2012 when the Fund began paying monthly distributions

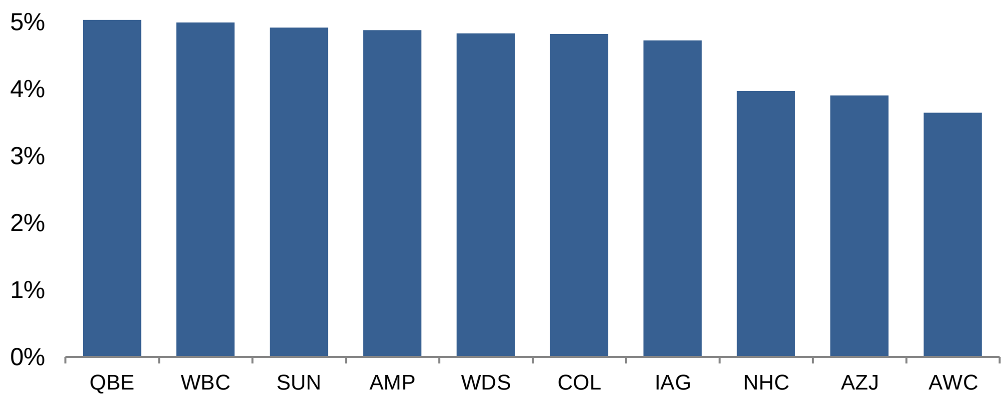
Figure 6: Cumulative income on $100,000 invested in July 2012



Source: Fidante, cumulative distributions and franking credits from July 2012 when the Fund began monthly distributions.

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.

Figure 7: Top ten holdings (gross weights)



Source: Merlon

Figure 7: Portfolio Analytics

	Portfolio	ASX200
Number of Equity Positions	35	200
Active Share	81%	0%
Merlon Valuation Upside	43%	-5%
Mid-cycle Free Cash Flow Yield	7.2%	5.1%
EV / EBITDA (year ahead)	10.4x	14.0x
Price / Earnings Ratio (year ahead)	11.7x	15.9x
Price / Book Ratio (year ahead)	1.9x	3.2x
Net Exposure		100%

Source: Merlon Capital Partners

Portfolio Analytics: Valuation upside based on Merlon estimates of sustainable free cash flow & franking credits. Price earnings ratio based on Bloomberg consensus estimates over next 2 financial years, annualised & time weighted. EPS growth based on annualised growth between last reported fiscal year and Bloomberg consensus EPS in 3 years' time. Ex Ante Tracking Error calculated using 60 month volatility and correlation data.

Summary of key holdings

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, provide long term inflation protection, have minimal debt and are still generating margins below historic levels despite the COVID demand boost.

IAG is the largest Australia and New Zealand general insurance company. The company is undervalued relative to our valuation, as the market is concerned by shorter term earnings risks posed by the relatively high short term claims environment, business interruption charges, and some loss of market share, particularly in motor. Yet valuing the company on the basis of a modest normalisation of insurance margins driven by higher rates, coupled with valuing the company's cashflows on an appropriate cash flow multiple sees appealing valuation upside.

QBE is a leading global insurer, seeing the strongest rate increase environment in 20 years. The company is undervalued relative to our valuation, as the market is concerned by persistent earnings disappointments, as well as shorter term claims risks from business interruption and wild weather. With these concerns already reflected in the price, and our expectations that insurance margins are likely to overshoot to the upside given rate increases, we anticipate the market will ultimately recognise and value a likely 8% mid-cycle free cashflow yield, plus franking.

Suncorp is a large domestic insurance and banking company. The company is undervalued relative to our valuation, as the market is concerned by shorter term earnings risks posed by the relatively high short term claims environment and business interruption charges. Yet valuing the company on the basis of a modest normalisation of insurance margins driven by higher rates, coupled with valuing the company's cashflows on an appropriate cash flow multiple sees appealing valuation upside. Further upside may be achieved via a favourable sale of the company's banking division.

Westpac is undervalued with the market assuming returns are structurally lower as a result of lower interest rates and higher operating and compliance costs. Despite having a similar business mix and track record of "underlying returns" relative to CBA, the bank continues to trade at an unusually large discount reflecting less confidence in management, persistent mortgage market share losses, a higher cost base than peers and recurring "non-recurring" items. We expect these concerns to ease over time, with investors rewarded with a 7% mid-cycle free cash flow yield in the interim.

Links to Previous Research

ESG Integration - Philosophy

Running on Empty

Forecasting with Humility

Who's Got the Energy

Australian Private Health Insurance

COVID-19 - One Year On

Interest Rates & Inflation

Reinventing Value Investing

The Merlon Approach to Corporate Governance

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?

Good Companies not Always Good Investments

Housing Cracks Present Material Opportunities

Iron Ore: Supply Disruption is Temporary

Trade Wars and the Peak of the Chinese Growth Model

Rethinking Post Retirement Asset Allocation

Some Thoughts on Asset Prices

Value Investing - An Australian Perspective: Part III

Value Investing - An Australian Perspective: Part II

Value Investing - An Australian Perspective: Part I

Some Thoughts on Australian House Prices

Iron Ore is Well Above Sustainable Levels

Why Telstra could be worth less than $2

The AMP Valuation Case

A Case Study in Poor Capital Allocation

Asaleo Divestment Well Received

Some More Thoughts on Telstra

Amazon Revisited - Muted Impact So Far

Digital vs. Traditional Media - A Global Trend

Oil: The Cycle Continues

Telstra Revisited

The Case for Fairfax Media Over REA Group

Amazon Not Introducing Internet to Australia

Boral's High Priced Acquisition of Headwaters

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Monthly Fact Sheet – May 2022

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