Merlon Australian Share Income Fund

Quarterly Report – September 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	$954m
Strategy FUM	$540m
Fund FUM	$392m
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)

AMP Limited	New Hope Corporation Ltd
BHP Limited	QBE Insurance Group Limited
Coles Group Ltd	Suncorp Group Ltd
IAG Limited	Westpac Banking Corporation
Qantas Airways Limited	Woodside Petroleum Limited

Fund Performance net of all fees and expenses

%[1]	Fund	Benchmark[2]	Yield[4]
Since Inception[3]	6.9	6.7	9.6
10 years (p.a)	8.5	7.6	7.4
5 Years (p.a)	5.6	6.3	6.9
3 Years (p.a)	4.5	3.3	6.5
1 Year	3.1	-4.0	6.3
FYTD	2.7	0.9	2.0
Quarter	2.7	0.9	2.0
1 Month	-3.7	-3.9	0.9

[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.

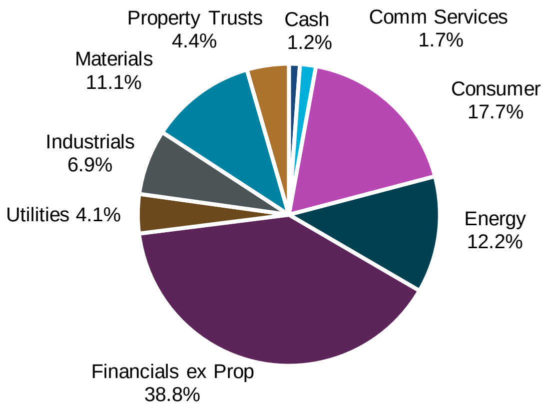
[3]The Inception Date for the fund is 30 September 2005.

[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 September 2022.

Sector Exposure



Quarterly value added relative to benchmark

Top 5	Value Added (%)
New Hope Corporation Ltd	1.9
AMP Limited	0.7
Insignia Financial Ltd	0.5
A2 Milk Co Ltd	0.4
Qantas Airways Limited	0.3

Bottom 5	Value Added (%)
Pilbara Minerals Ltd	-0.3
Suncorp Group Ltd	-0.4
Newcrest Mining Limited	-0.4
CSL Limited	-0.6
Unibail Group Stapled	-0.8

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

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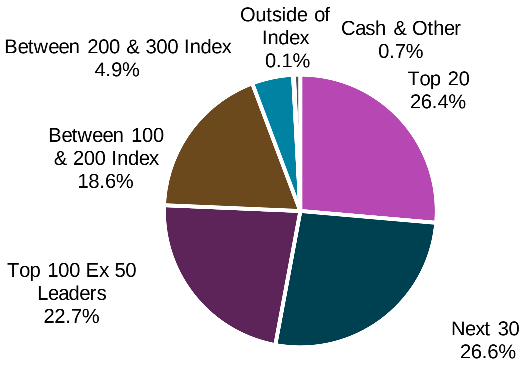
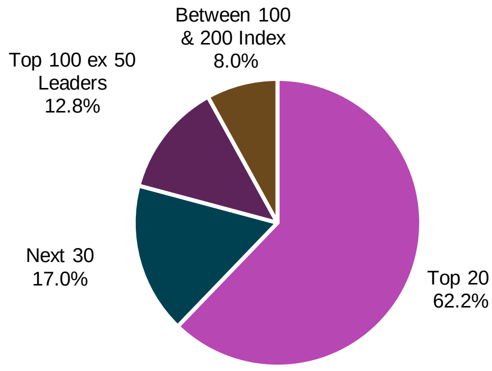
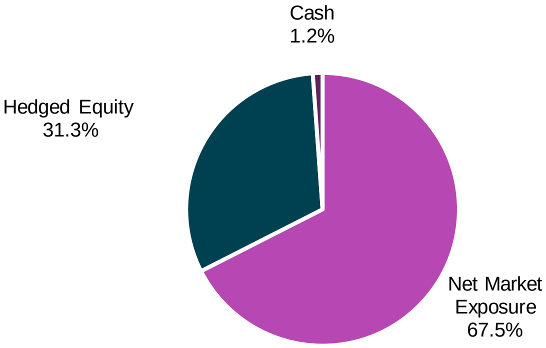
Market Cap Bands – Fund



Market Cap Bands – ASX 200



Asset Allocation



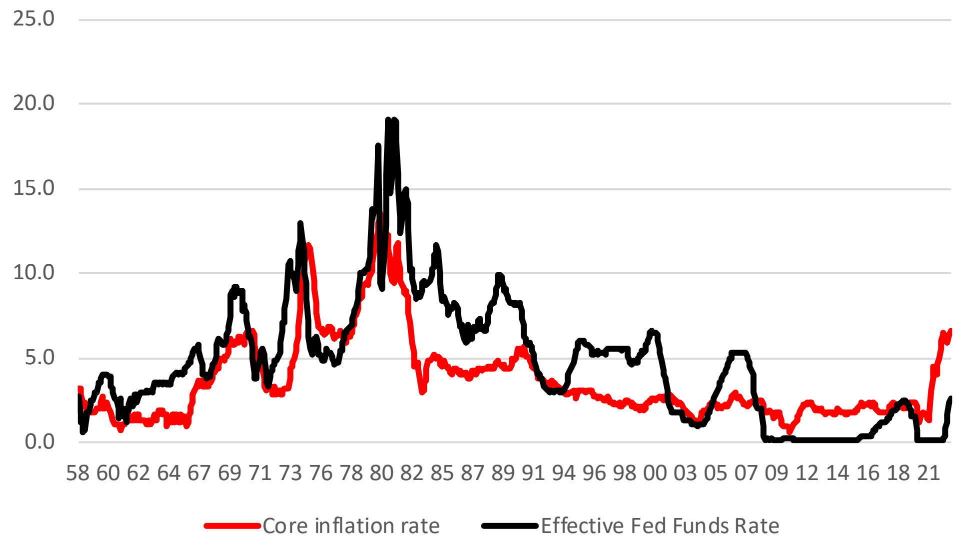
Market Review and Outlook

The Australian market produced a 1.1% return (including franking) during the quarter. Positive returns from the Energy, Health Care and Information Technology sectors largely offset negatives from the Utilities, Real Estate, and Industrials sectors. While Russia's continued military engagement with Ukraine supported energy prices, continued rate rises by central banks globally saw a growing weight over the market. This is not only a function of higher cost of financing economic activity via interest rates, but also the effect of the stronger US currency relative to most other currencies, effectively transmitting higher USD-denominated goods and services prices into these weaker-currency nations, a secondary overhang on activity.

Although inflation has to date proven less transitory than expected, and the US Federal Reserve continues to chase it, there may be some early signs of an easing of expectations. The 2021 market thesis was that as the COVID-driven logistics constraints unwound, and the COVID-stimulus effects on demand faded, price pressures would ease. However, through the effects of Russia's invasion of Ukraine in significantly disrupting global energy markets, existing pressures on energy markets were greatly magnified.

Fearful of a repeat of the 1970s energy-driven inflation era, central banks globally moved quickly to commence an aggressive tightening phase. The effects of this policy synchronisation on recession expectations have, in turn, seen energy prices decline, in turn seeing inflation expectations begin to turn also (see Figure 2). While headline rates remain higher than desired, expectations may indicate a turning point is nearing.

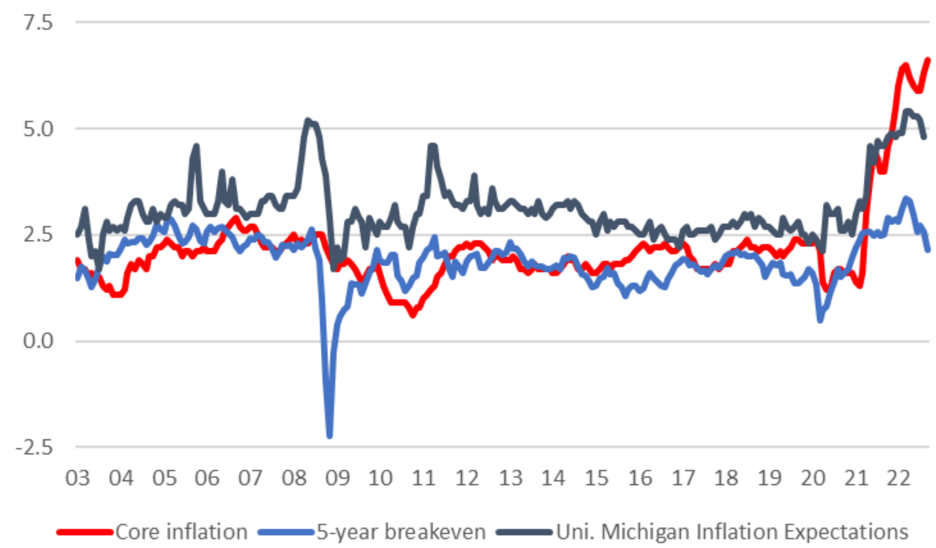
Figure 1: inflation & Fed response



Sources: Federal Reserve of St. Louis. Bloomberg. Calculations: Merlon.

Markets remained focused on the risks of recession, as well as US Mid-Terms and Biden's response to OPEC+ production target cut, as well as China's National Congress, which is expected to see a third term for President Xi. Perhaps more importantly is whether Xi, post confirmation of a third term, moves to relax his 'dynamic zero' COVID policy, which has seen it become a global outlier in terms of policy. Such as relaxation would see support for the global economy and commodity markets as the world's second largest economy and largest population is able to regain mobility once more.

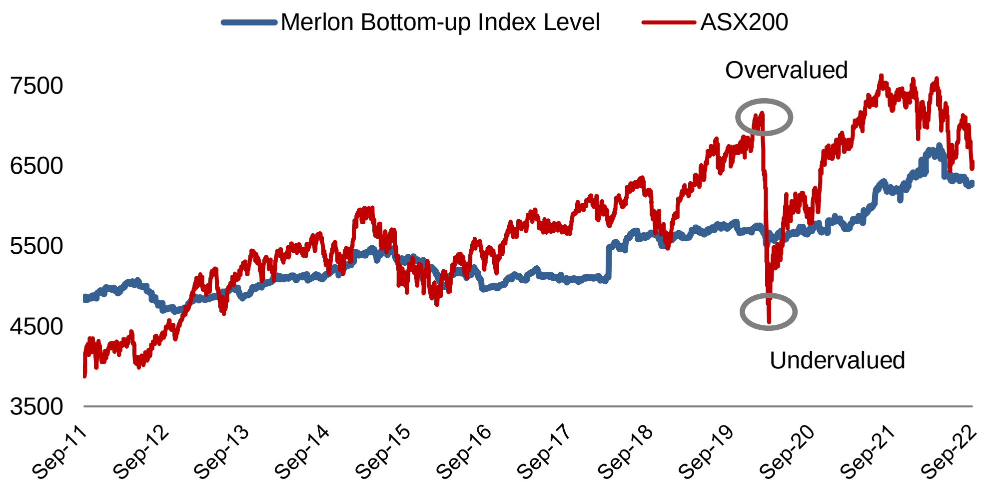
Figure 2: inflation vs inflation expectations (survey & market implied)



Sources: Federal Reserve of St. Louis. Bloomberg. Calculations: Merlon.

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 150 stocks we actively cover. Unlike the modelled 20% overvaluation seen at the end of 2021, the market is approaching our assessment of fair value.

Figure 3: Merlon bottom-up market valuation vs ASX200 level

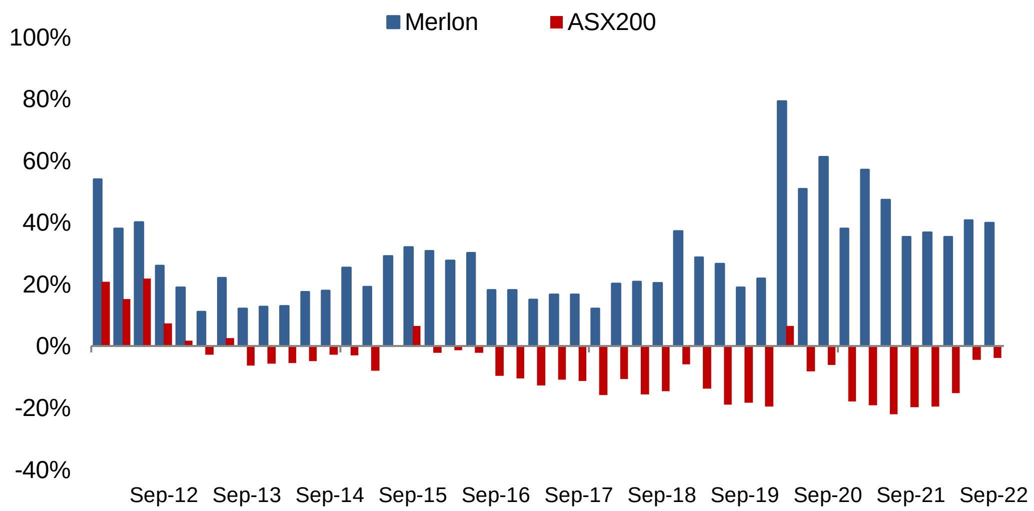


Source: Merlon

US Treasury yields accelerated above 3% in the first half of 2022. Following a decline over the course of July, as recessionary expectations grew, yields increased once more, approaching 4%. The Fed has been somewhat ahead of the curve across central banks globally, resulting in a US dollar strengthening by 15-20% against major trading partners. Ironically, with the Fed moving early to address inflation through tightening domestic rates in order to slow domestic activity, the stronger currency will see the US also 'exporting' inflation through cheapening the cost of imports. The US is also privileged in its domestic energy supply, which keep a lid on the prices of energy, one of the major causes of inflation to begin with.

To this end, the portfolio's focus on cashflows over longer dated growth expectations should perform relatively well compared to the broader market. Tempering this scenario would be an adverse economic response to higher rates, coupled with a 'walk-back' of Fed normalisation.

Figure 4: Expected return based on Merlon valuations



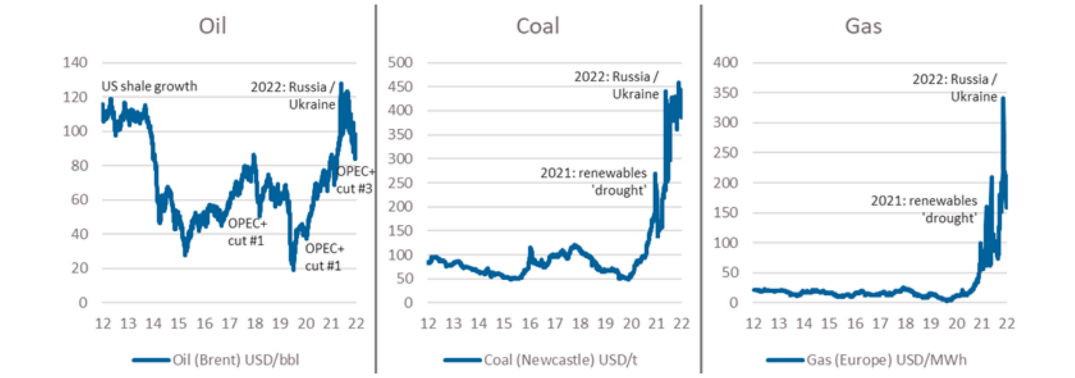
Source: Merlon

Energy markets update: Given Russia's importance to the global **oil** supply (~10%), it appears surprising that oil has rallied, yet significantly underperformed gas and coal since the beginning of the year. Yet with 3-5% of additional supply to come from OPEC as it normalises its COVID supply cuts, coupled with Russia's ability to redirect oil to other destinations, oil markets remain adequately supplied.

In the case of **gas**, on the other hand, supply has been tight since 2021, when northern hemisphere renewable energy experienced prolonged underperformance, and demand for gas rose to backstop electricity grids. As a large supplier of gas into Europe (50% of gas imports), Russia's supply of gas has come increasingly into question as supplies have declined in response to Western sanctions on Russian oil.

And **coal**? Coal and gas are close substitutes in electricity generation, with coal prices retaining their relationship with gas. Gas flow disruptions from Russia into Europe are seeing previously idled coal-plants restarted, and demand for coal rising. Of relevance for Australian producers is the desire to replace high CV (energy) Russian coal volumes (also 50% of European coal imports) with 'like' high CV product, which is largely only available in scale from Australia.

Figure 5: pricing of carbon intensive fuels



Sources: Federal Reserve of St. Louis. Bloomberg. Calculations: Merlon.

Portfolio Review

Quarter: The portfolio outperformed the Benchmark by 1.7% (net inclusive of franking) over the quarter. Extending the trends seen in the prior quarter, energy-related companies continued to outperform. New Hope Coal was the largest contributor along with in AMP, A2 Milk and Insignia (formerly IOOF). Detracting from performance during the quarter (but not outweighing positive performers noted) were overweight positions in Unibail-Rodamco-Westfield, Newcrest Mining, and Suncorp, and underweight positions in CSL and Pilbara Mineral.

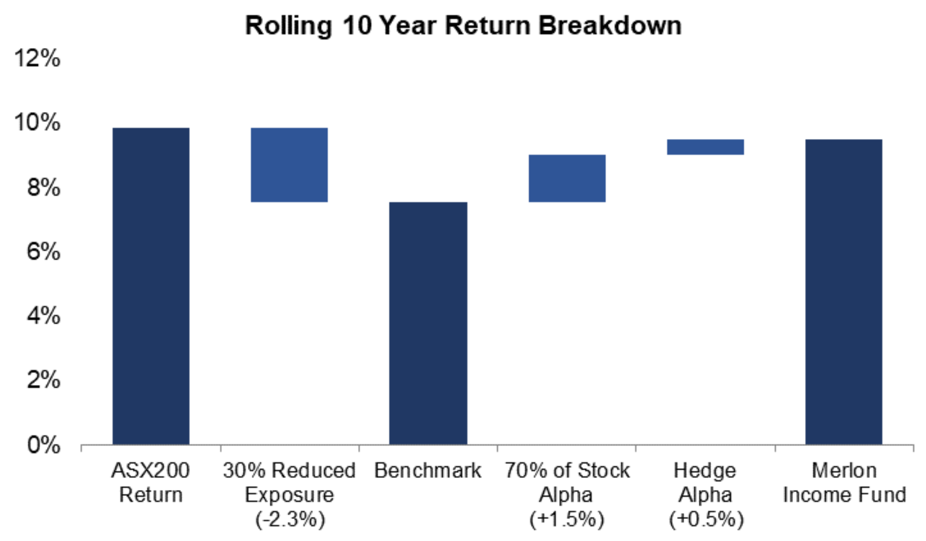
The risk reduction overlay detracted 0.6% during the quarter, less than would be expected given the 5.9% return from the underlying share portfolio.

12 months: The portfolio outperformed the Benchmark by 7.0% (net inclusive of franking) over the year, with strong contributions from the coal names, New Hope and Whitehaven, while we also saw Woodside, Origin and Santos also perform strongly. These oil and gas names, in particular, saw the previously noted discount to oil and global peers continue to narrow as expected (hoped). Detracting from performance during the year (but not outweighing positive performers noted) were the large underweight positions in BHP and National Australia Bank, as well as overweight exposures in Unibail-Rodamco-Westfield, Alumina and Insignia Financial.

The risk reduction overlay provided a slightly positive 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.

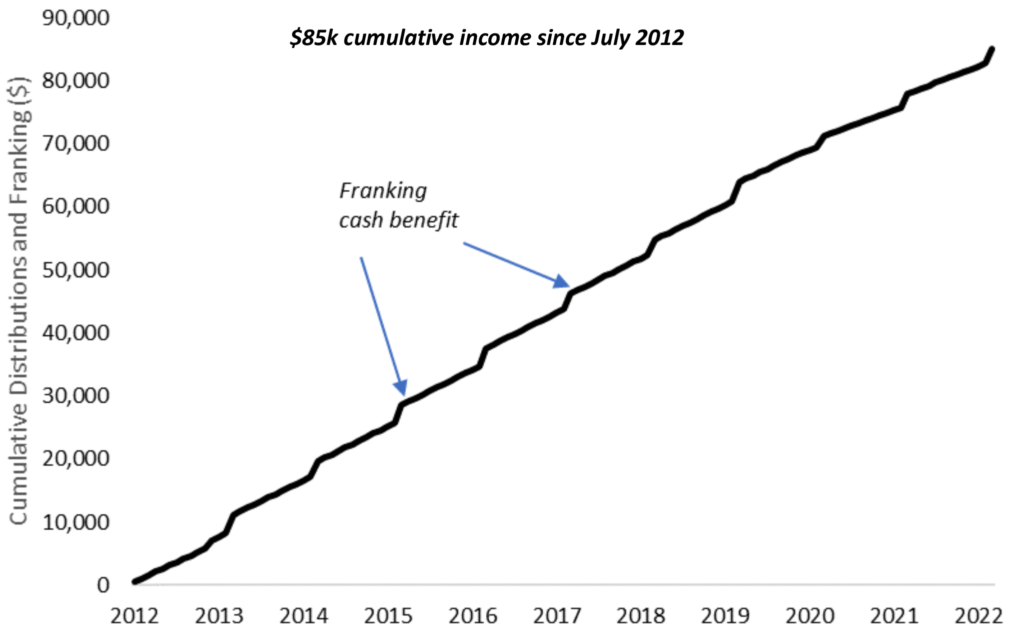
Figure 6: Drivers of performance



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 7.5%, or 1.6% 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.

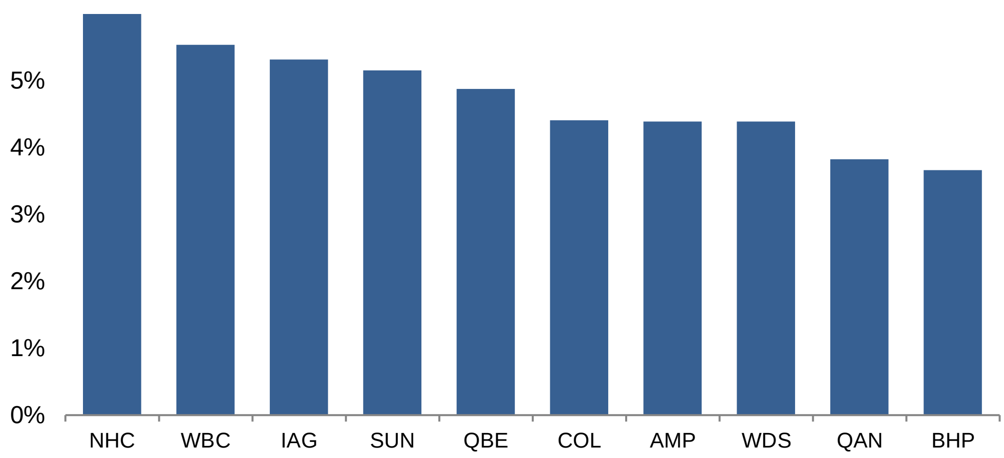
Figure 7: Cumulative income on $100,000 invested in July 2012



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 8: Portfolio Analytics

	Portfolio	ASX200
Number of Equity Positions	36	200
Active Share	76%	0%
Gross Yield	8.5%	6.5%
Mid-cycle Free Cash Flow Yield	6.7%	5.1%
Merlon Valuation Upside	40%	-4%
Price / Earnings Ratio (year ahead)	11.6x	15.7x
Net Exposure	67%	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

New Hope Group was an investment made in early 2020, as coal prices had trended below the cost of production across more than half the industry, globally. The came amidst an extended period of coal asset underinvestment as returns had declined with prices, and capital had become increasingly scarce as ESG considerations became more dominant. These two factors gave us confidence that prices were increasingly likely to base and recover, rather than continue falling, as loss-making assets ceased production, and the extended period of underinvestment made the energy complex vulnerable to supply and / or demand shocks.

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.

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.

AMP remains undervalued and, now the sale of the private markets fund manager is largely complete, has significant scope for capital returns to shareholders. With a market cap of only $3.7b, this implies negligible value for the remaining businesses, including $68b in contemporary platform FUM, a well-funded low-cost bank with $21b loan book, a New Zealand wealth business, surplus capital (including the "board buffer") and currently loss-making advice and master trust businesses (we assume zero long-term value for these). The challenge will be successfully exiting the loss-making businesses without impacting the growing valuable businesses within the group. Governance failures have been largely addressed with a renewed board and management.

QAN is the leading Australian airline. We believe the market continues to undervalue the company as it waits for the airline to return to pre-COVID profitability and negative publicity weighs on its reputation. We note that operational issues have faced airlines globally and despite popular media opinion, Qantas is taking market share from Virgin Australia - reflecting its superior competitive position & improved domestic industry structure. QAN remains attractive at 4x FY24 EBITDA with meaningful upside to domestic yields and margins.

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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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