Merlon Australian Share Income Fund

Quarterly Report – September 2023

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	$1,075m
Strategy FUM	$591m
Fund FUM	$424m
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)

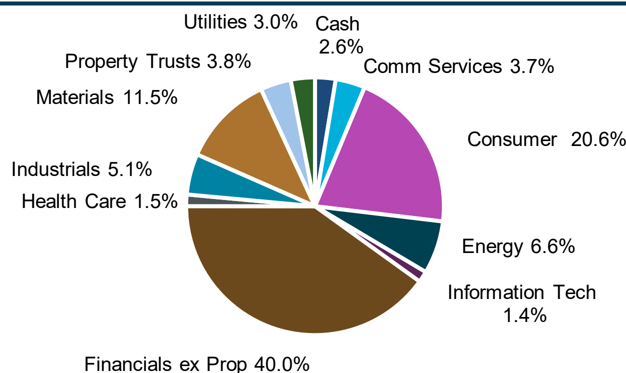
AMP	News Corporation
Coles Group	QBE Insurance Group
CSR	Santos
Insurance Australia Group	Treasury Wine Estates
Medibank Private	Westpac Banking Corporation

Fund Performance net of all fees and expenses

%[1]	Fund	Benchmark[2]	Yield[4]
Since Inception[3]	7.3	7.0	9.5
10 years (p.a)	7.5	6.9	7.1
5 Years (p.a)	7.5	6.3	6.8
3 Years (p.a)	14.6	9.2	6.7
1 Year	15.3	11.6	6.6
FYTD	-1.4	0.2	1.5
Quarter	-1.4	0.2	1.5
1 Month	-2.5	-1.7	0.6

[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 2023.

Sector Exposure



Quarterly value added relative to benchmark

Top 5	Value Added (%)
CSL	0.5
AMP	0.5
Treasury Wine Estates	0.4
News Corporation	0.3
CSR	0.3

Bottom 5	Value Added (%)
a2 Milk Co	-0.5
Healius	-0.5
Coles Group	-0.6
Alumina	-0.8
Star Entertainment Grp Ltd	-0.8

Source: Fidante Partners Limited, 30 September 2023. Benchmark is S&P/ASX 200 Accumulation

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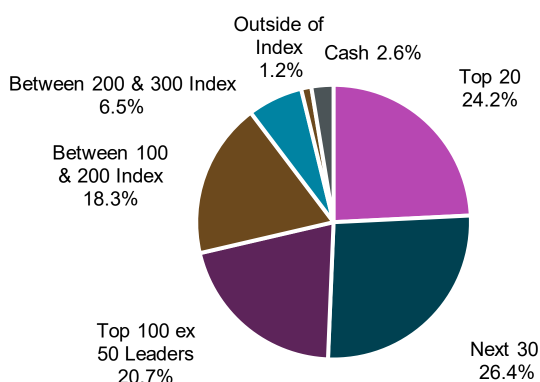
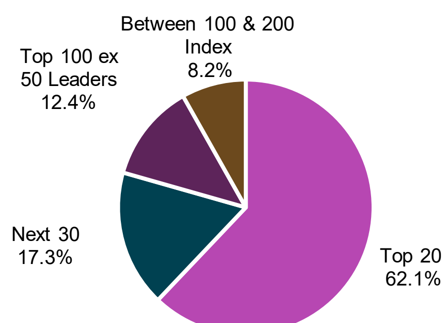
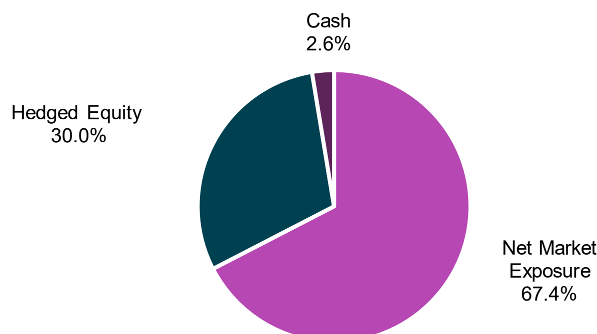
Market Cap Bands - Fund



Market Cap Bands – ASX 200



Asset Allocation

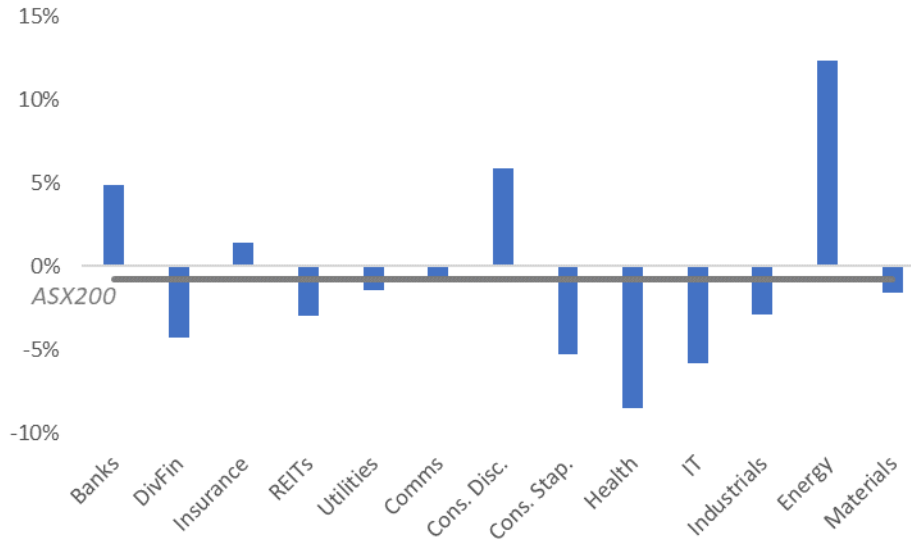


Market Review

The September quarter saw US Treasuries continue to rally, with yields rising from 3.8% to 4.6% in the space of just three months. While the backdrop of the rising risk-free rate saw global markets decline by 3.7%, the Australian market declined by 'only' 0.8%. This strong relative return came primarily from the Energy sector, which we discuss below, with the Banking sector, which saw record dividends declared, and the Consumer Discretionary sector, which saw better than expected results in the context of a slowing economy, as the only other notable outperformers during the quarter.

The standout Energy sector was buoyed by Saudi Arabia's commitment to restraining oil output into year-end, sparking a rally in the oil price from USD75/bbl to USD95/bbl. While our suspicion is that Saudi restraint may say more about potentially weakening demand, the US economy continues to print surprisingly resilient economic data points, and expectations are that the US Federal Reserve may be nearing an end to its tightening cycle. Yet with US mortgage rates now back to 2000-levels, it could be premature to suggest that the US and in turn global economy are out of the woods for either inflation or economic growth. And in a perhaps circular manner, the strong rally in oil prices is not necessarily consistent with inflation relief.

Figure 1: Australian equity sector performance

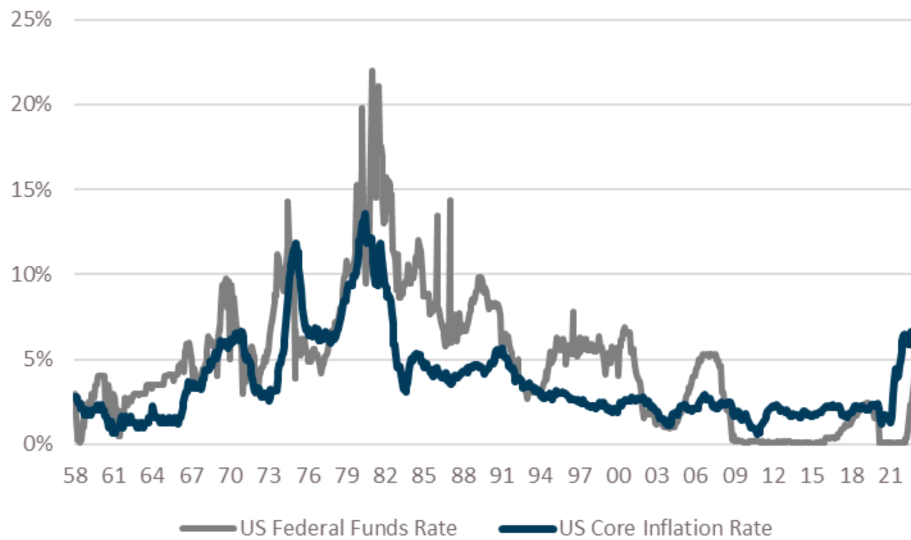


Source: Merlon Capital Partners, Bloomberg

The impact of taming inflation

With COVID-led supply constraints and fiscal stimulus, and with Russia's invasion of Ukraine combining to drive inflation above the tolerance levels of central banks, we have seen an unprecedented co-ordinated and rapid increases in official interest rates.

Figure 2: US Core Inflation Rate vs US Federal Funds Rate



Source: Federal Reserve Bank of St. Louis

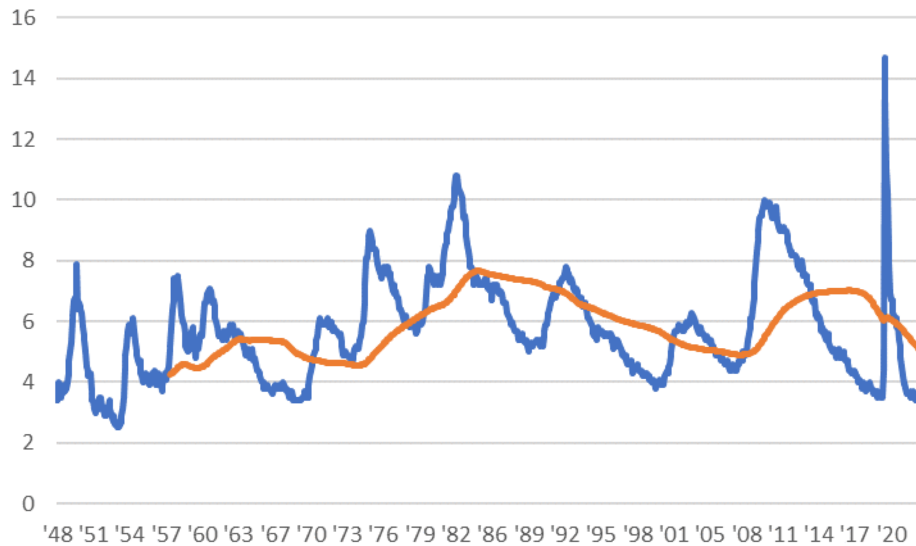
Market yields have risen in tandem as markets factor in a potentially higher rate of inflation longer term. With the cost of money for household, corporate and government borrowers rising, the prospects of an economic slowdown have grown (as intended by central banks). The result has been particularly pronounced for those seeking a home loan, with US mortgage rates now back to the turn of the millennium.

Figure 3: US Mortgage Rate

Source: Federal Reserve Bank of St. Louis

While markets have been supported by persistently strong economic data points, most notably unemployment levels, history shows things can change quickly. And with inflation now lower, but still above tolerance levels, the flexibility of central banks to loosen aggressively is lower than that seen over the past several decades.

Figure 4: US Unemployment Rate



Source: Federal Reserve Bank of St. Louis

While not a base case, observing the history of inflationary periods also demonstrates that if it is not sufficiently controlled at its outset, there is a risk of multiple subsequent inflationary waves. These phases can also be ultimately outside the control of central banks in situations where the origins of the inflation are derived from instability in large energy producing regions of the world including Russia and the Middle East.

Portfolio Review

September Quarter:

The Fund underperformed the Benchmark by 1.2% (including fees and franking credits) during the quarter. Key performance drivers for the period were from the following positions:

Positive contributors:

- **CSL (underweight):** continued to decline off its COVID peaks, as it struggles with the impact of elevated donor fees on margins, and as it continues to lose share to key rival Takeda.
- **AMP (overweight):** outperformed following its full year result announcement, with banking and investment platform earnings higher, and with the company noting an ambitious cost-out target.
- **Treasury Wine Estates (overweight):** benefited from the thawing of geopolitical tensions between Australia and China, with the barley tariff removals viewed by the market as increasingly the likelihood of the wine tariff removal.
- **News Corporation (overweight):** benefited from its full year result showing strong earnings growth, in particular in its Dow Jones and News Media divisions.
- **CSR (overweight):** outperformed as the downturn in the Australian housing market has proven less severe to date than expected, following aggressive RBA interest rate hikes.

Negative contributors:

- **Star Entertainment Group (overweight):** continued to struggle as the company attempt to navigate an increasingly restrictive regulatory environment aimed at curbing problem gaming.
- **Alumina Limited (overweight):** was impacted by disruptions to its planned mining activities following a referral to the Environmental Planning Agency by the WA Forest Alliance.
- **Coles Group (overweight):** underperformed as the market was the company reported a slower than expected unwind of COVID costs, coupled with a higher capex program to increasingly automate its warehouse capabilities.
- **Healius (overweight):** was impacted by pathology volumes remaining weak in the face of an expected recovery, flowing through to continued low margins from elevated fixed costs and higher interest costs.
- **A2 Milk Company (overweight):** underperformed as market expectations for China births in 2023 deteriorated, albeit offset by market share gains.

The risk reduction overlay contributed positively during the quarter, insulating the Fund from some of the falls in the underlying share portfolio.

Longer Term

The Fund has outperformed by 5.4% p.a. over the past three years and 1.2% p.a. (including fees and franking credits) over five years. Contributions over this period have come from a variety of sectors including Energy, Consumer, Health, Insurance and Utilities, demonstrating the flexibility of our approach, coupled with its disciplined implementation during more difficult periods.

Given the strong returns from the underlying share portfolio the risk reduction overlay detracted, albeit by less than expected given the structurally lower equity exposure.

From an income perspective the Fund has delivered a gross distribution yield above the ASX200 every year since inception.

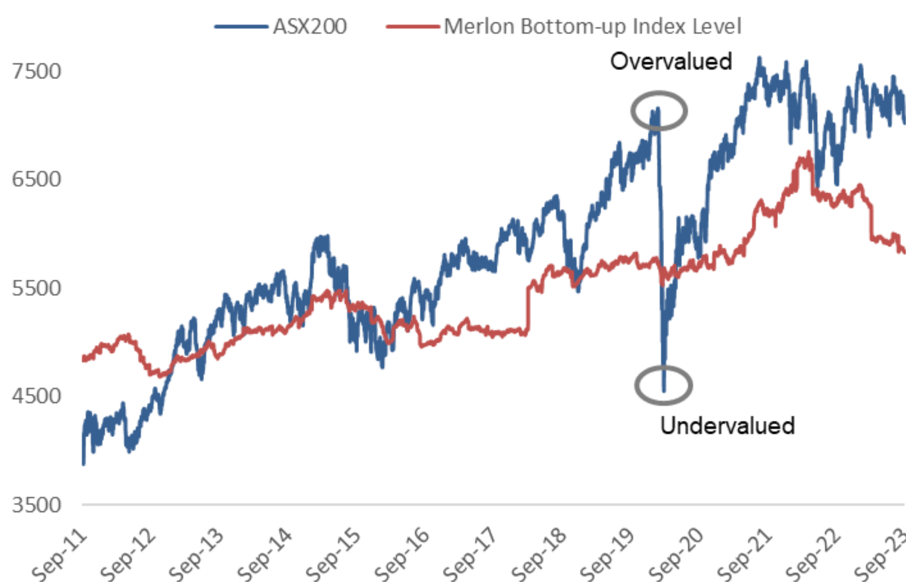
Portfolio Activity

During the quarter, we initiated positions in **Amcor**, **ASX, Downer Group, Dexus** and **Treasury Wine Estates**. To fund these positions, we exited positions in **NIB Holdings** and **Suncorp** and materially reduced **Origin Energy** and **Woodside,** which had outperformed and therefore had less valuation upside. The position in Incitec Pivot was exited as while the company was trading towards our valuation mid-point, yet with increasingly uncertain capital strategy. Energy-related positions **Origin Energy** and **Woodside** were fully exited, having been steadily reducing over time following outperformance relative to our valuation range, based on long-term Brent oil price of US$60-120/barrel.

Portfolio Outlook

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. While not as overvalued as the end of 2021, the market was 18% overvalued at the end of the 2023 financial year.

Figure 4: Expected return based on Merlon valuations



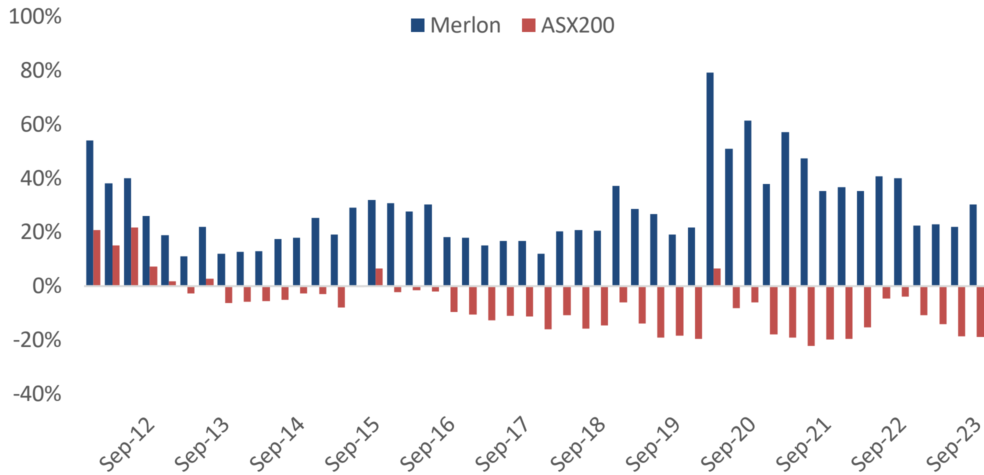
Source: Merlon Capital Partners

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.

While we are not macro investors, as discussed above there are clearly some macro themes inherent within the portfolio. We need to be aware of these themes and ensure they do not expose us or our clients to unintended or unbalanced risks. We seek to manage any such risks by our strategy of investing in companies that are under-valued and where investors have become overly pessimistic about long term prospects on account of weaker short-term performance. We assess the degree of pessimism by considering the company's market value in relation to a sensible valuation range with a particular focus on the downside risk scenario. Attractive valuations strongly imply that market concerns are – at least to some extent – already reflected in expectations and provide some "margin of safety" in the event conditions deteriorate.

As can be seen in Figure 5, the Merlon portfolio continues to offer attractive upside as it has over the past 12 years, with the key being the expected return spread over the market. This gives us confidence we can continue to outperform over the medium and longer term.

Figure 5: Expected return based on Merlon valuations

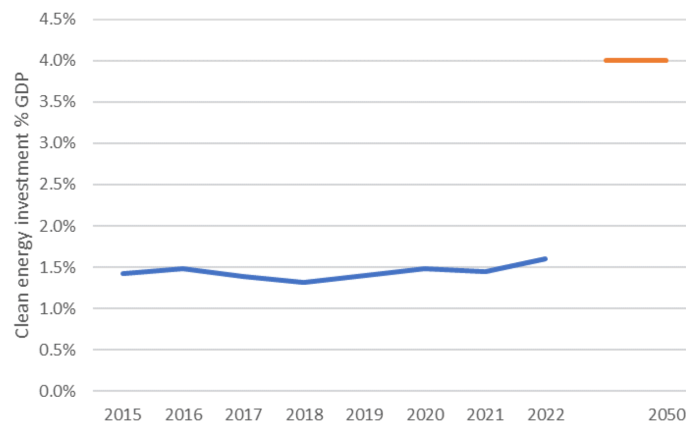


Source: Merlon Capital Partners

From a short-term perspective, inflation and inflation expectations are still too high (albeit less so than in prior quarters) and markets may not be adequately priced for persistently high inflation in our view. A pause in central bank rhetoric runs the risk of a reacceleration of inflation, with the longer inflation remains elevated comes the greater the risk of wage-price spirals. It is also unclear the extent of economic (and earnings) pain required to return inflation to central bank target levels. Furthermore, we have only recently ended 14 years of unconventional interest rate policy that has suppressed discount rates and inflated most asset values.

In addition, and perhaps most under-appreciated by markets, is that while conventional energy costs have declined, the cost of installing future sources of energy are rising and are set to rise further, with investment levels needing to nearly triple from current levels to meet global net-zero ambitions. It is becoming increasingly likely that such high levels of spending via the globally co-ordinated, and increasingly desperate attempt to secure supplies of key materials and componentry, relative to what remains a highly concentrated supplier base, is increasingly likely to result in inflationary pressure.

Figure 6: Clean energy investment required to meet net zero by 2050



Source: International Energy Agency. World Bank. Calculations: Merlon Capital Partners.

We believe our portfolio is well positioned, at least in a relative sense, if inflation proves more persistent as we focus on under-appreciated cashflow rather than longer dated growth potential at low discount rates and have consistently factored in higher (3%) real bond yields. These higher yields are consistent with history which extends beyond the period of central bank meddling with bond purchases and reflects a risk premium for inflation volatility.

Our portfolio is also well positioned, again at least in a relative sense, for an economic and earnings downturn. We are materially underweight late-cycle banks which are not pricing in the inevitable turn in the credit cycle and are now underweight commodity-

exposed stocks (principally iron ore and now energy too) which will not be immune from the lagged global economic slowdown triggered by rapidly higher interest rates. As we wrote about in our Covid Roadmap in 2020, leverage is the enemy in downturns and there are no more leveraged stocks than the banks, property and infrastructure stocks. The risk reduction overlay will also provide meaningful protection in this scenario.

As it did in the most recent quarter and during the 2017 to 2019 period, our portfolio might lag a strong market if central banks do an about-turn and engineer more record stimulus to push real bond yields back towards zero or below. Investors might consider this a risk worth taking in exchange for a portfolio of companies with absolute upside through a focus on cash generation, conservative approach to leverage and overly pessimistic market expectations, without needing assistance from lower real interest rates.

Figure 7: Portfolio Analytics

	Portfolio	ASX200
Number of Equity Positions	37	200
Active Share	76%	0%
Gross Yield	6.9%	6.2%
Mid-cycle Free Cash Flow Yield	7.3%	4.8%
Merlon Valuation Upside	30%	-19%
Price / Earnings Ratio (year ahead)	15.0x	16.9x
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.

Stock in Focus

Downer (DOW) is a large Australia and New Zealand infrastructure and facilities management company, which is operating in a concentrated industry structure. The company designs, builds and maintains assets, infrastructure and facilities across sectors including transport, utilities, defence, and facilities, employing more than 30,000 employees.

To be a good investment, we need to understand the concerns that are driving a company to be undervalued by the market, and either prove these concerns are not valid or that the worst-case outcome is more than factored into the share price. With DOW, we believe the market is undervaluing the company relative to its potential to return to more normal levels of profitability, and for the company to operate in a way that no longer risks capital misallocation.

In addition to deep fundamental research and rigorous peer review, we have a formal engagement programme with the board of directors around the time of initial investment. We write a letter with the purpose of introducing Merlon, outlining our investment thesis, summarising key Environmental, Social and Governance (ESG) issues and ultimately engaging directly with the company. In this case, we have formally initiated engagement with the DOW Board, via a letter to directors outlining our investment thesis including valuation range, key ESG issues identified, and any recommendations for improving outcomes.

We value DOW at between $4.40/share and $6.00/share based on the following long-term assumptions and segment valuations:

Segment	Low	High	Key Assumptions
Transport	$2.8b	$3.0b	$280-300m sustainable earnings
Utilities	$0.5b	$1.0b	$50-100m sustainable earnings
Facilities	$1.5b	$1.9b	$150-190m sustainable earnings
Corporate costs	($1.2b)	($1.2b)	Based on 12 months to June 2023
Net Debt	($0.7b)	($0.7b)	June 2023 book value
Franking Credits	$0.0b	$0.0b	70% of face value
Equity value*	**$2.9b**	**$4.0b**	
Equity value per share	**$4.40**	**$6.00**	

*Numbers may not add up due to rounding

We believe the market is too pessimistic about DOW's ability to address the issues that are restraining its earnings potential and remains concerned by the risk of continued capital misallocation. While this market pessimism has been justified for some time, we believe the company's new management team and Board are incentivised to address these issues and to drive the business in a return to its strengths and in turn a return to more normal levels of profitability. In response to this letter, we are now in the process of scheduling a meeting with the DOW board in order to discuss our own valuation range, and to discuss more broadly ESG issues we have identified.

MERLON CAPITAL PARTNERS

Links to Previous Research

- Energy system stability: risks, opportunities & the decarbonised future
- 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

This material has been prepared by Merlon Capital Partners (ABN 94 140 833 683, AFSL 343753) Merlon, the investment manager of the Merlon Australian Concentrated Australian Share Fund. Fidante Partners Limited ABN 94 002 835 592 AFSL 234668 (Fidante) is a member of the Challenger Limited group of companies (**Challenger Group**) and is the responsible entity of the Fund. Other than information which is identified as sourced from Fidante in relation to the Fund, Fidante is not responsible for the information in this material, including any statements of opinion. It is general information only and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider, with a financial adviser, whether the information is suitable to your circumstances. The Fund's Target Market Determination and Product Disclosure Statement (PDS) available at www.fidante.com should be considered before making a decision about whether to buy or hold units in the Fund. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. Past performance is not a reliable indicator of future performance. Merlon and Fidante have entered into arrangements in connection with the distribution and administration of financial products to which this material relates. In connection with those arrangements, Merlon and Fidante may receive remuneration or other benefits in respect of financial services provided by the parties. Fidante is not an authorised deposit-taking institution (ADI) for the purpose of the *Banking Act 1959* (Cth), and its obligations do not represent deposits or liabilities of an ADI in the Challenger Group (**Challenger ADI**) and no Challenger ADI provides a guarantee or otherwise provides assurance in respect of the obligations of Fidante. Investments in the Fund are subject to investment risk, including possible delays in repayment and loss of income or principal invested. Accordingly, the performance, the repayment of capital or any particular rate of return on your investments are not guaranteed by any member of the Challenger Group.