Merlon Australian Share Income Fund

Quarterly Report – June 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)

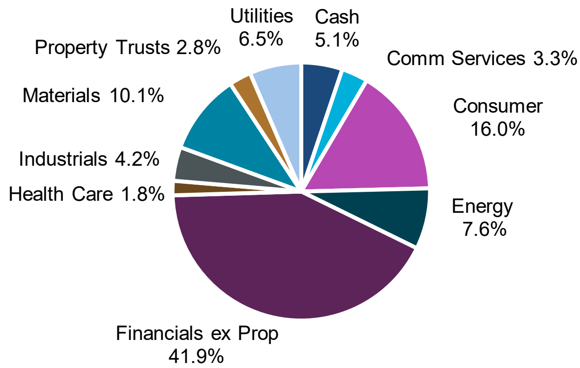
a2 Milk Co	Medibank
AGL Energy	QBE Insurance Group
BHP	Santos
Coles Group	Suncorp Group
Insurance Australia Group	Westpac Banking Corporation

Fund Performance net of all fees and expenses

%[1]	Fund	Benchmark[2]	Yield[4]
Since Inception[3]	7.5	7.1	9.5
10 years (p.a)	8.4	7.7	7.2
5 Years (p.a)	8.1	6.6	6.9
3 Years (p.a)	13.9	9.2	6.7
1 Year	19.9	12.4	7.2
FYTD	19.9	12.4	7.2
Quarter	5.4	1.1	1.4
1 Month	2.4	1.3	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 2023.

Sector Exposure



Quarterly value added relative to benchmark

Top 5	Value Added (%)
AGL Energy	1.3
Insurance Australia Group	1.0
News Corporation	0.6
Suncorp Group	0.5
BHP	0.4

Bottom 5	Value Added (%)
Unibail Group	-0.1
James Hardie Industries	-0.2
Alumina	-0.2
Xero	-0.2
a2 Milk Co	-0.4

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

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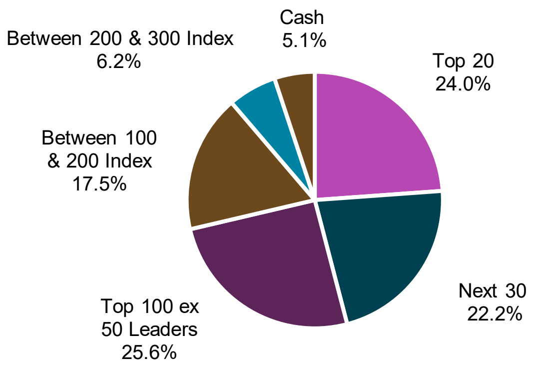
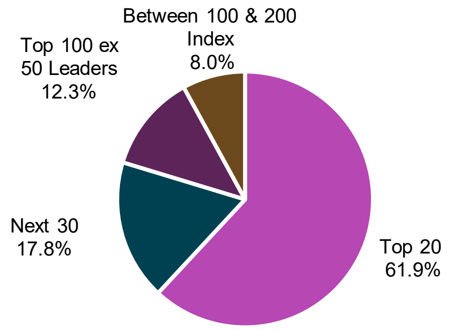
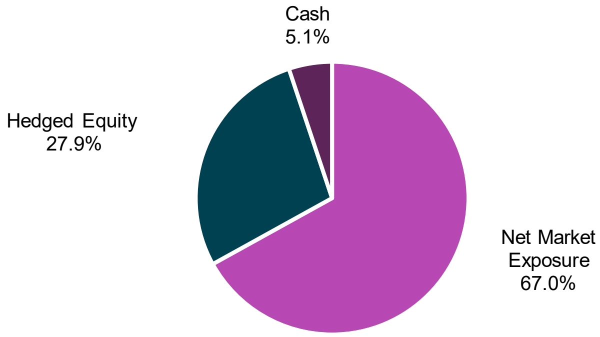
Market Cap Bands - Fund



Market Cap Bands – ASX 200



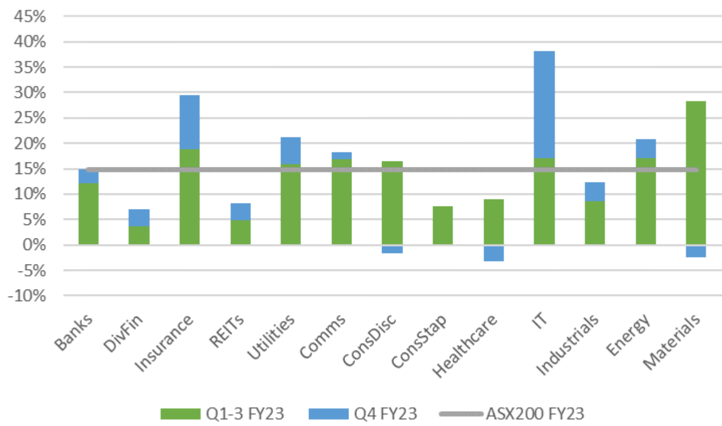
Asset Allocation



Market Review

The final quarter of Financial Year 2023 saw expectations of a US recession and a peaking of rates unwind as economic data points from the United States indicated greater than expected levels of resilience. For the Australian market, the final quarter of FY23 saw the ASX200 rise by 1.0 per cent, capping a strong year totalling 14.8 per cent. The Insurance sector was a positive for the quarter and year, as a beneficiary of higher rates. The Utilities sector benefited from the Origin Energy takeover proposal by Brookfield, and AGL's growing leverage to higher electricity prices. The Technology sector also benefited, as investors sought to anticipate rates peaking, and the growing excitement surrounding the potential of Artificial Intelligence.

Figure 1: Australian equity sector performance



Source: Merlon Capital Partners, Bloomberg

Also driving market returns was the Materials sector, which had rallied strongly on China's surprise COVID reopening. Sector performance then faded as these optimistic expectations for a direct flow through to a strong economic recovery began to falter, albeit resulting in subsequent expectations grow for an aggressive policy response. Our view is that even with an aggressive attempt to revitalise the property sector (not our base case) calendar year steel production limits remain likely, which would imply overall demand for iron ore may fall in the December half, as June half steel production grew relative to 2022.

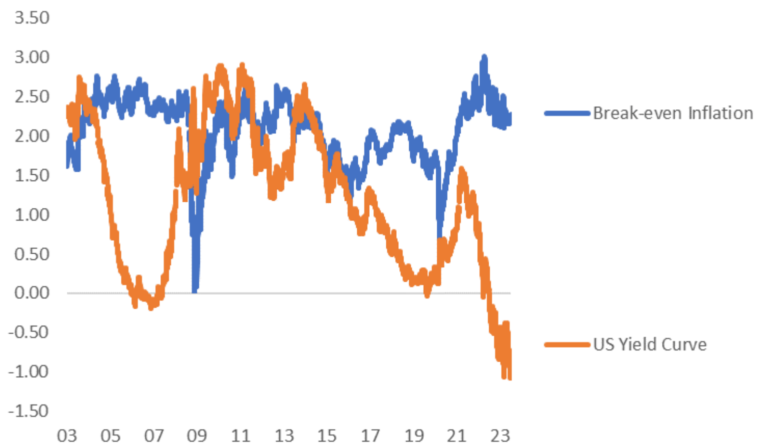
Banks and other financials-exposed sectors underperformed as investors became increasingly concerned over the impact of higher rates on debt servicing as well as broader financial contagion risks as evidenced by several offshore financial institution failures in prior quarters.

Somewhat converse to resilience in the US economy were weak oil prices. This was perhaps more a function of sanctions on Russian oil being ineffective. Gas and hence coal prices also continued to fall throughout the year, as European demand weakened, and supplies proved more than adequate despite Russian pipeline flows being cut.

Inflation, interest rates and recessions

We have seen inflation expectations moderate, as central banks globally continue to raise official interest rates, and energy prices continue to moderate, despite continued Russian military activity in Ukraine. In response, we have seen markets price in a growing likelihood of recession, as indicated by the strongly negative US yield curve (see following chart).

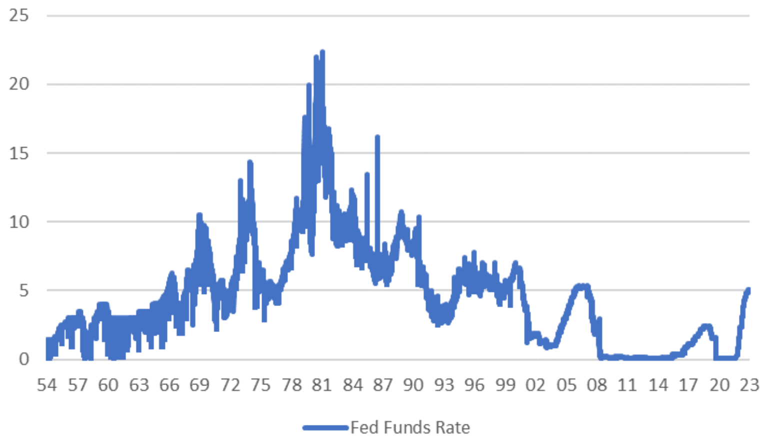
Figure 2: US Break even inflation vs US yield curve



Source: Federal Reserve Bank of St. Louis

Yet while rates have risen at an unprecedented speed (see chart below), it is still debateable whether they are now 'high' or just 'normal' in comparison to the extended post-GFC phase of 'unconventional' monetary policy. Of course, the level is only a function of an observer's point of reference. While they may not be high on a longer-term basis, the overall level may be of less relevance than the interest servicing requirements on debts raised over the past decade, with the interest burden of these debts rapidly eating into alternative spending routes of consumers, corporations and governments, and hence a hard or soft landing yet to be determined.

Figure 3: US Federal Funds effective rate



Source: Federal Reserve Bank of St. Louis

And while reported inflation is still above central bank inflation targeting ranges, consumer expectations of future inflation are displaying signs of moderation, with three-year levels having fallen back into 'comfortable' levels. While rates appear likely to rise further, inflation expectations mean there may be less work to do for central banks from here, at least in addressing inflationary effects of the post-COVID / Russia/Ukraine situations. Inflation risks of the future remain, however and are addressed in our market outlook below.

Portfolio Review

June Quarter:

The Fund outperformed over the quarter, returning 5.4% (after fees and including franking credits). Key positive contributing exposures during the quarter included overweight positions in **AGL Energy**, which benefited from the market's realisation that operational issues impacting returns has been addressed, and that higher electricity prices relative to the company's fixed cost base would flow through to improved earnings; and **IAG**, which benefited from the market's expectation of an improving policy pricing cycle.

Also assisting were overweight positions in **News Corporation**, and **Aurizon**, as well as an underweight position in **BHP**. Negative contributions from overweight positions in **A2 Milk**, **ANZ**, and **Alumina** were not sufficient to offset these positive contributors.

The risk reduction overlay was a detractor for the quarter, as expected given the underlying share portfolio returned 6.1%. The performance of the overlay was ahead of the targeted net exposure of 70% with the Fund retaining ~88% of the underlying share portfolio's return.

Financial Year

The Fund also outperformed returning 19.9% (after fees and including franking) during the financial year. Key performance drivers for the period were from the following positions:

Positive contributors:

- **AGL (overweight):** benefited from market realisation that operational issues impacting returns has been addressed, enabling greater flow through of higher electricity prices relative to the company's fixed cost base which would drive higher earnings.
- **Whitehaven / New Hope (overweight):** continued to generate unprecedented cashflows from record coal prices following prolonged industry underinvestment, which had left the sector unable to respond to demand spikes from COVID reopening, the northern hemisphere's renewable energy generation 'drought', and Russia's invasion of Ukraine.
- **Super Cheap Retail (overweight):** benefited from continued strong sales figures, and a subsequently strong earnings report delivered in February.
- **Qantas (overweight):** benefited from improved business and leisure passenger activity following COVID reopening and the return to more normal operating conditions.
- **Origin Energy (overweight):** was buoyed by the company noting operating issues affecting its generation portfolio had been largely resolved, and the subsequent takeover proposal by the consortium comprised of Canadian private equity Brookfield and US energy investor EIG.

Negative contributors:

- **BHP (underweight):** benefited from expectations that China's COVID-reopening would drive an improved operating environment for real estate construction activity.
- **Newcrest (underweight):** saw the takeover proposal from Newmont mining, despite our view that the gold price was significantly above levels implied by real interest rates on US treasury bonds.
- **Unibail Rodamco Westfield (overweight):** was impacted by lacklustre performance in its European operations, and concerns over the impact of rising interest rates on the company's debt position.

Similar to the June quarter, the risk reduction overlay detracted, albeit by less than expected given the structurally lower equity exposure.

The Fund delivered a gross yield of 7.2%, ahead of the market.

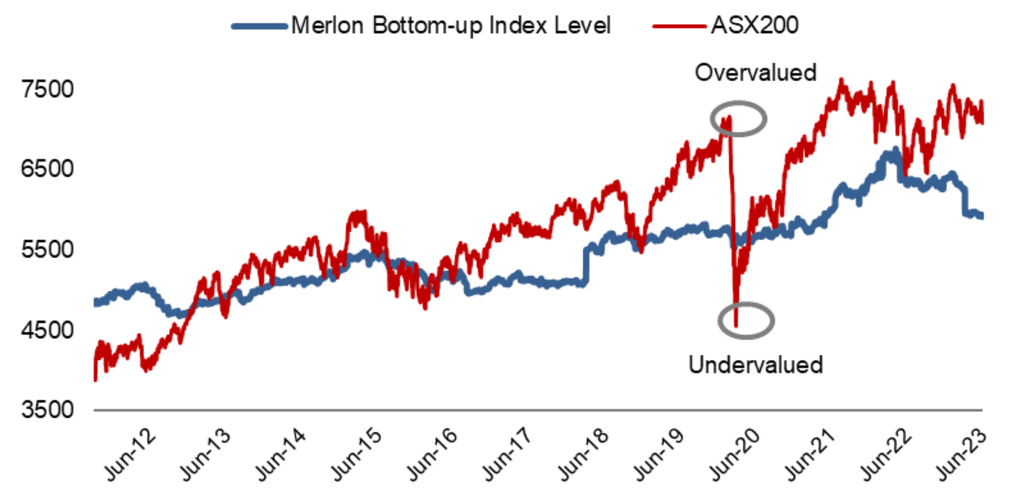
Portfolio Activity

During the quarter, we initiated positions in **Star Entertainment**, **Bank of Queensland** and **Fletcher Building**, and added to existing investments in **A2 Milk**, and **CSR**. To fund these additions, we exited positions in **Qantas**, **Scentre Group** and **New Hope**, and reduced positions in **Suncorp**, **IAG**, and **Super Retail**, all of which outperformed and therefore had less valuation upside. We also reduced energy-related positions such as **Origin Energy** and **Woodside** following outperformance relative to our valuation range, based on long-term Brent oil price of US$60-100/barrel, and **New Hope** and **AGL Energy**, which had benefited from the market increasingly pricing in unsustainably high energy prices.

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



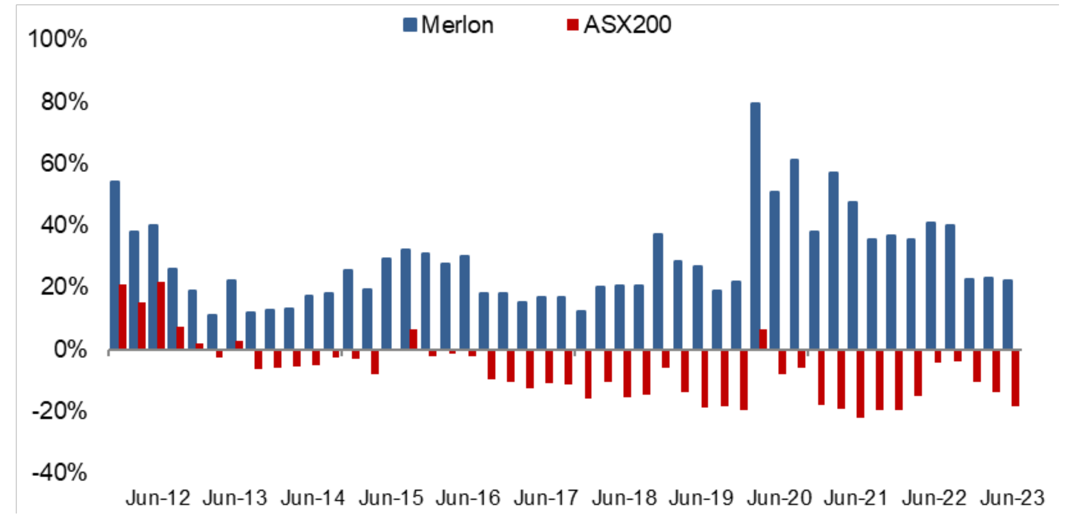
Source: Merlon Capital Partners

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

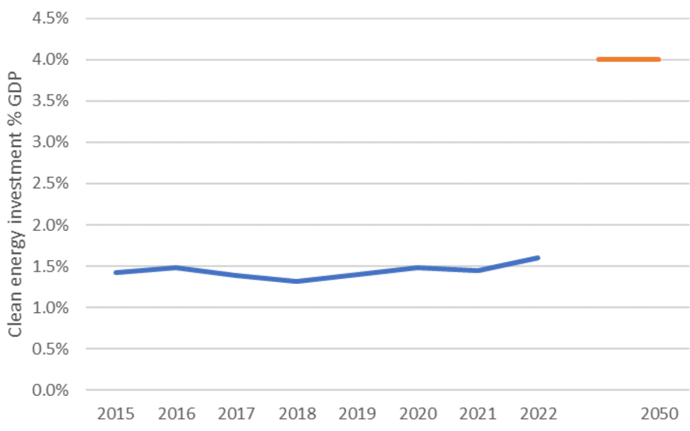


Source: Merlon Capital Partners

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	35	200
Active Share	76%	0%
Gross Yield	9.0%	6.2%
Mid-cycle Free Cash Flow Yield	7.1%	4.8%
Merlon Valuation Upside	22%	-18%
Price / Earnings Ratio (year ahead)	14.6x	16.9x
Net Exposure	68%	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

nib Insurance (NHF) is a large Australia and New Zealand health insurance company, which is operating in a relatively concentrated industry structure. The company provides health and medical insurance to more than 1.5 million Australian and New Zealand residents, as well as 180,000 international students and workers in Australia.

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 NHF, we believe the market is undervaluing the company relative to other similarly defensive companies. Further, we believe the company's historical record of cash-conversion is under-appreciated.

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 NHF 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 NHF at between $5.90/share and $10.50/share based on the following long-term assumptions and segment valuations:

Segment	Low	High	Key Assumptions
Australia	$2.2b	$4.1b	5-9% margins @ 2-5% investment return rates
New Zealand	$0.3b	$0.5b	8-12% margins @ 2-5% investment return rates
Travel	$0.2b	$0.3b	12-18% margins
Unallocated capital	$0.2b	$0.2b	Assumes PHI requires NTA of 16% of premiums
Excess reserves	$0.1b	$0.1b	Book value of deferred & suspended claims
Net debt	($0.2b)	($0.2b)	Book value
Associates	Small	Small	Book value
Franking	$0.1b	$0.1b	70% of face value
Equity value*	**$2.9b**	**$5.1b**	
Equity value per share	**$5.90**	**$10.50**	

*Numbers may not add up due to rounding

We believe the market has underestimated the long-term growth trajectory for the industry, underwritten by the aging population and the ongoing need for the private sector to contribute to associated health costs. Further, we do not believe earnings upside from higher interest rates is fully reflected in market expectations. In July 2021, we shared more detailed thoughts in relation to the private health insurance sector (available on our website: https://www.merloncapital.com.au/australian-private-health-insurance/).

In response to this letter, we are now in the process of scheduling a meeting with the NHF board in order to discuss our own valuation range, and to discuss more broadly any ESG issues we have identified.

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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