Merlon Australian Share Income Fund

Quarterly Report – March 2024

For queries, please call Investor Services on 1300 721 637

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 / Andrew Fraser
Fund inception date	30th September 2005
Merlon FUM	$808m
Strategy FUM	$658m
Fund FUM	$491m
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)

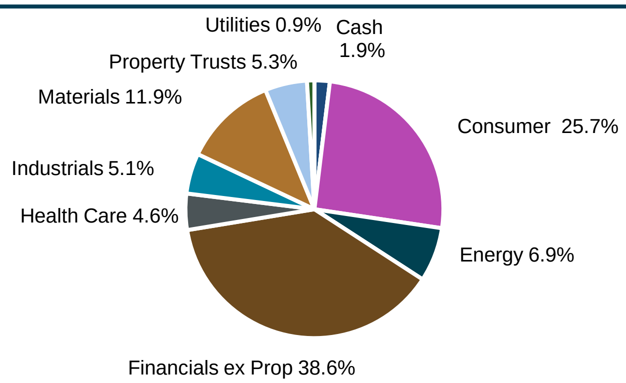
a2 Milk Co	CSR
Alumina	Insurance Australia Group
AMP	QBE Insurance Group
ASX	Santos
Coles	Westpac

Fund Performance net of all fees and expenses

%[1]	Fund	Benchmark[2]	Yield[4]
Since Inception[3]	7.8	7.4	9.4
10 years (p.a)	8.3	7.6	7.1
5 Years (p.a)	9.9	8.1	6.7
3 Years (p.a)	13.0	8.5	6.6
1 Year	17.0	12.4	6.4
FYTD	11.0	11.2	4.8
Quarter	10.2	4.4	1.6
1 Month	4.3	2.6	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, 31 March 2024.

Sector Exposure



Quarterly value added relative to benchmark

Top 5	**Value Added (%)**
a2 Milk Co	1.4
Alumina	1.2
BHP Group	1.1
CSR	0.9
QBE Insurance Group	0.8

Bottom 5	**Value Added (%)**
Healius	-0.4
Commonwealth Bank Of Australia	-0.4
Wesfarmers	-0.5
Fletcher Building	-0.5
Goodman Group	-0.6

Source: Fidante Partners Limited, 31 March 2024. Benchmark is S&P/ASX 200 Accumulation Index

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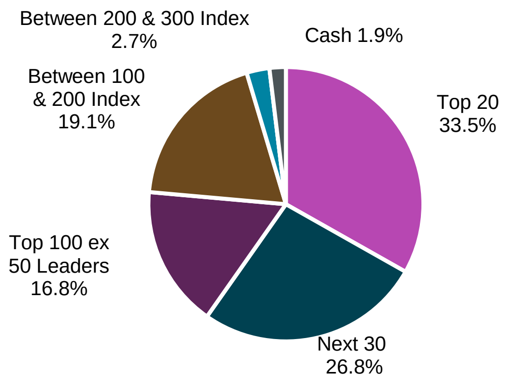
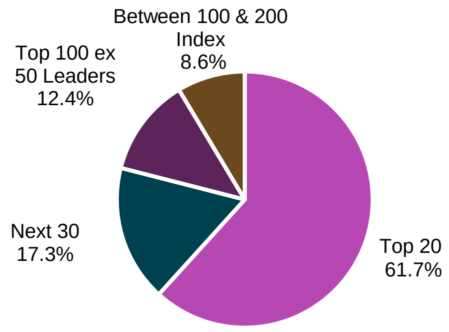
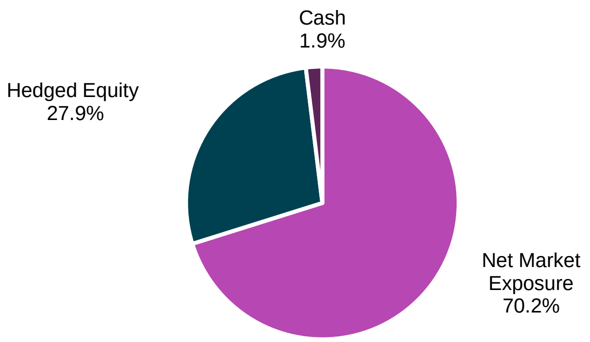
Market Cap Bands - Fund



Market Cap Bands – ASX 200



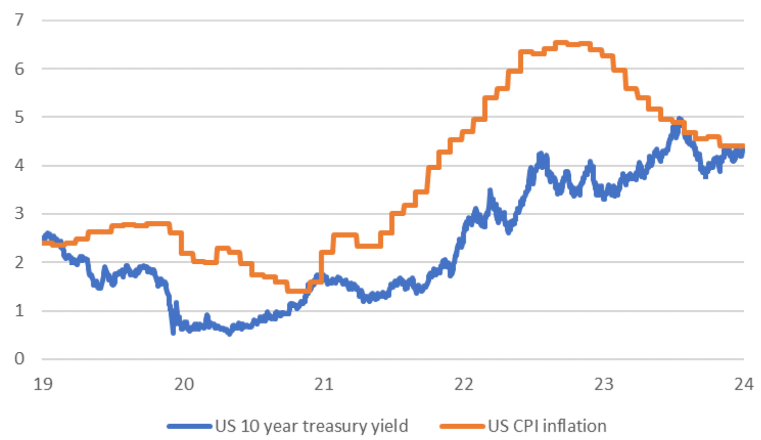
Asset Allocation



Market Review

While US inflation continued to ease through the first quarter of 2024, its pace of easing appeared to moderate. In recognition of this, yields on US treasuries actually increased over this period, from 3.9% to 4.2%. And data more recently - from a strengthening manufacturing PMI to stronger jobs market - suggest an economy strengthening, despite prior concerns over the effect of the rapid, globally coordinated official rate rises designed to cool the economy, and in turn, inflation. If the US does in fact continue to strengthen, it could prove to be one of the only times the widely trusted recession indicator of an inverted yield curve was incorrect.

Figure 1: US treasuries vs inflation

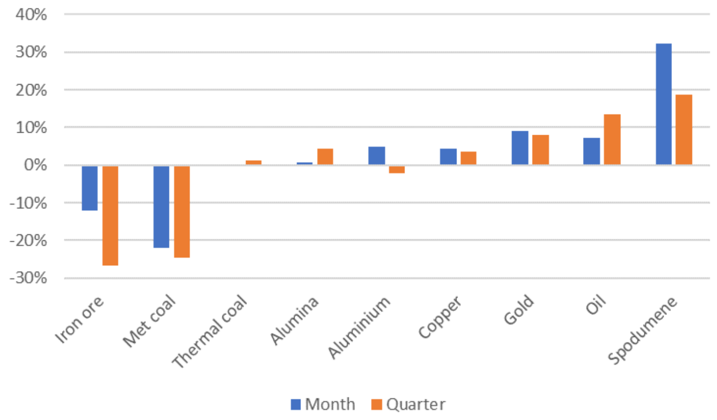


Source: Merlon Capital Partners, Federal Reserve of St. Louis.

Market expectations for longer term inflation rates appear to have returned to a 'normal' level of 2.0-2.5%. This is to suggest a definition of normal that is above the 2015-2020 levels, a period corresponding to the ultra-low average risk-free rate of 2.5%.

The ASX200 rose strongly into 2024, recording a 3.3% rise in March to cap off a +5.3% quarter. , with industrials outperforming resources by 15%. Within the resources sector, there was wide dispersion, with energy, based metals and gold exposed companies outperforming, while China exposed lithium and iron ore names underperformed.

Figure 2: commodity price changes

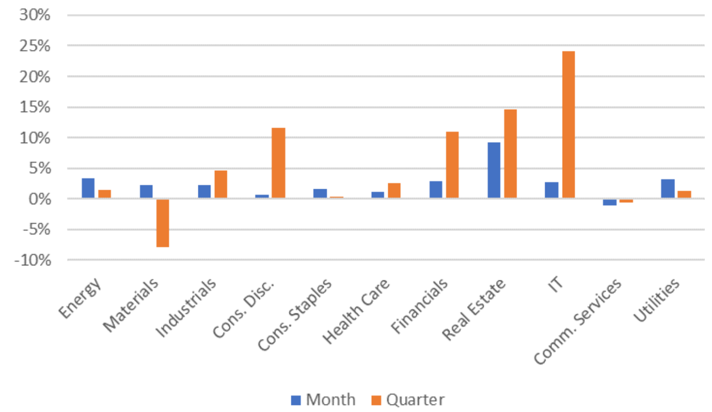


Source: Merlon Capital Partners, Bloomberg.

At a sector level, **Technology** performed the best, tracking the NASDAQ and bonds. Other positive sectors included **Consumer Discretionary,** reflecting low earnings expectations, **Insurance**, tracking lower claims and higher rates, and **REITs**, albeit most of the gains in the last quarter.

The worst performing sectors over the year were Materials, led lower by weak iron ore and lithium prices (see chart above), outweighing the positive gold sector. **Consumer Staples**, and **Healthcare**, all partly reflecting high premiums paid for defensiveness amidst a market starting to consider a growing economy as an increasingly likely scenario. And the **Energy** sector, while very modestly positive for the quarter, underperformed the 14% return from oil, a commodity in tune with the improved demand expectations.

Figure 3: sector returns



Source: Merlon Capital Partners, Bloomberg.

Portfolio Review

Month: The Fund **outperformed the Benchmark by 1.8%** during the month. Key performance drivers for the period were from the following positions:

Positive contributors:

- **Alumina Limited (overweight):** rallied 34% as the takeover offer from parent company Alcoa of America was confirmed.
- **Unibail Group (underweight):** continued to rally as markets anticipated a basing of the global economy, and expectations of an easing interest rate environment.
- **a2 Milk (overweight):** continued to outperform following its positive result and outlook commentary (see below).

Negative contributors:

- **Goodman Group (underweight):** outperformed on expectations of an improving economic environment, and interest rate expectations shifting to the beginning of an easing cycle.
- **Fletcher Building (overweight):** continued to underperform following its poor result announced in February and management turnover (see below).
- **CSR (overweight):** having rallied by 30% in late February, following the takeover offer by French company Saint-Gobain, traded like cash in March, underpinned by the offer, while the ASX continued to rally on expectations of lower rates.

Given the positive returns from the underlying share portfolio the risk reduction overlay detracted, but will provide material protection if markets fall.

Quarter: The Fund **outperformed the Benchmark by 6.1%** during the quarter. Key performance drivers for the period were from the following positions:

Positive contributors:

- **BHP (underweight):** underperformed as the deteriorating Chinese property sector seen in 2023 flowed through to lower demand for steel and in turn iron ore.
- **a2 Milk (overweight):** outperformed as it delivered a strong first half result and upgraded its sales guidance for the full year. The company also noted expectations of a stabilising Chinese infant formula market.
- **Alumina Limited (overweight):** the company announced in early January that it had determined to shut the loss-making Kwinana refinery. Alcoa subsequently announced it intended to acquire the 40% share of Alcoa World Alumina and Chemicals (AWAC) that it does not own, listed in Australia as Alumina Limited.

Negative contributors:

- **Fletcher Building (overweight):** the underperformed following its poor first half result announced in February, with the company subsequently announcing the exit of its CEO and Chair.
- **Goodman Group (underweight):** was impacted by disruptions to its planned mining activities following a referral to the Environmental Planning Agency by the WA Forest Alliance.
- **Wesfarmers (underweight):** outperformed as the company's Bunnings and Kmart businesses continued to perform well, despite its nascent lithium business subject to declining selling prices, as was its fertilisers business.

Given the positive returns from the underlying share portfolio the risk reduction overlay detracted, but will provide material protection if markets fall.

Longer Term: The Fund has outperformed by 5.6% p.a. over three years, 2.8% p.a. over five years, 1.7% p.a. over ten years and 1.4% p.a. since the strategy's inception in 2005. 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.

Portfolio Activity

Positions established:

- **Woolworths:** a position was established as the company underperformed, increasing the valuation appeal in what is a high-quality company, with the market likely too pessimistic about the impact of government scrutiny on supermarket pricing.
- **Ramsay Health Care:** a position was established as we view the market as over-extrapolating the post COVID decline in operating margins, particularly given the company's exposure to a growing and ageing population.
- Small positions were also established in **Whitehaven Coal** and **Sonic Healthcare**, on growing valuation appeal, while we made additions to positions in **Treasury Wine Estates** (see Stock in Focus section, below) and **AWC** following its announced closure of the Kwinana refinery in early January.

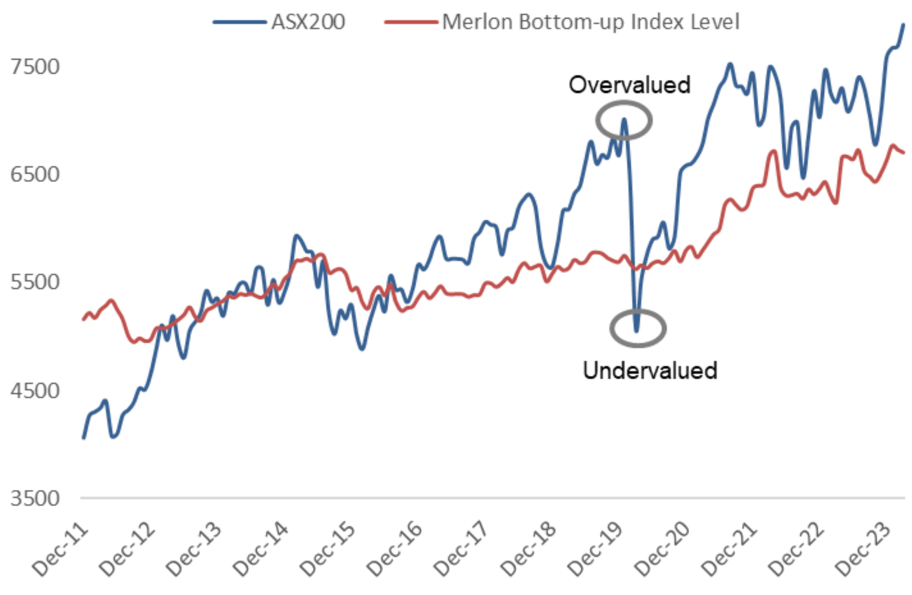
Positions exited:

- **News Corporation:** the position was exited following a period of strong outperformance, with the company trading above the upper end of our valuation range.
- **AGL:** the position was exited as the company appears likely to deliver declining earnings profile amidst post peak electricity pricing and appears determined to allocate capital into lower returning projects / acquisitions.
- Small positions in **Amcor** and **Helia Group** were exited during the period.

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. Following the rally this year, the market could be up to 15% overvalued based on long-term discount rates.

Figure 4: Expected return based on Merlon valuations



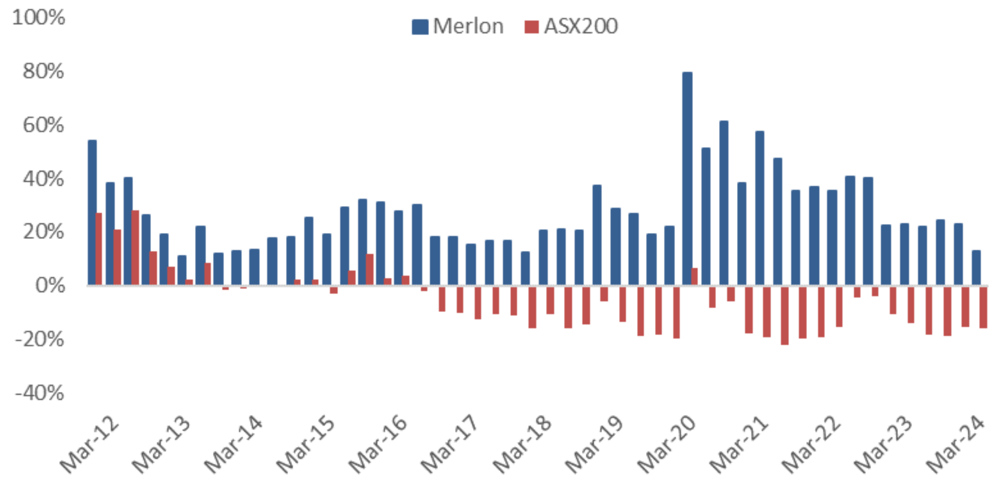
Source: Merlon Capital Partners

The portfolio reflects our best bottom-up fundamental views rather than macro or sector-specific themes. These are usually companies 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.

The Merlon portfolio continues to offer attractive upside as it has over the past 14 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 has decelerated and inflation expectations have rapidly moderated, however markets may not be adequately priced for persistently high and volatile 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.

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.

As it did in the most recent December 2023 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.

The Fund's net exposure as at the end of the quarter was 71%.

Figure 6: Portfolio Analytics

	Portfolio	ASX200
Number of Equity Positions	36	200
Active Share	73%	0%
Gross Yield	5.4%	5.0%
Merlon Valuation Upside	13%	-16%
Price / Earnings Ratio (year ahead)	17.6x	18.6x
Net Exposure	71%	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

Treasury Wine Estates (TWE) operates Australia's largest wine company, with 11,300 hectares of vineyards in servicing more than 70 countries and boasting one of the world's most highly regarded brands in its Penfolds label.

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.

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.

We value TWE at between $8/share and $17/share based on long-term assumptions and segment valuations:

While the shares have underperformed since our initial investment, in particular following its acquisition of the US based DAOU Vineyards, which underwhelmed the market. Having sought board engagement (see excerpt of letter below) and gained a fuller appreciation of the acquired business, we have increased our position.

In terms of regulatory risk, we acquired the shares when trading towards our low case valuation which we felt did not fully capture the anticipated impact of a lifting of Chinese tariffs on Australian wine imports (which occurred in March, with the company outperforming strongly).

Figure 7: Extract of letter to TWE Board

MERLON CAPITAL PARTNERS

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30 January 2024

Members of the Board of Directors
Treasury Wine Estates Limited
161 Collins Street
Melbourne, Vic 3000

Re: Introduction to Merlon Capital Partners

Ladies and Gentlemen:

[redacted]

For your records, Merlon Capital Partners ("Merlon" or "we") owns 2,297,009 shares in Treasury Wine Estates Limited ("TWE" or "the company") on behalf of our clients, being retail and institutional investors. The purpose of this letter is to i) introduce Merlon to the board of directors; ii) outline our TWE investment thesis; iii) provide an overview of our approach to Environmental, Social and Governance (ESG) matters; and iv) summarise key ESG issues identified to date in relation to TWE.

Introduction to Merlon
Merlon is a high conviction fund manager. Subject to continued due diligence, when we initiate an investment position in a company our intent is to build the position into a significant proportion of our portfolios, which in turn also represents a significant proportion of our own personal wealth. In addition to direct alignment with our clients through co-investment, our firm is majority owned by our staff and we recognise investment performance over the long-term is critical to its success

Investment Approach & TWE Investment Thesis
Our investment approach is to invest in undervalued companies where we think market participants have become too pessimistic. We value all companies by capitalising our assessment of sustainable earnings at multiples aligned with free-cash-flow generation. In the case of TWE, we value the company at between $8 and $17 per security. Our valuation is summarised below:

Segment	Low	High	Key Assumptions
Penfolds "as-is"	$4.0b	$6.9b	40-50% EBITS margin
Chinese tariff removal	$1.1b	$4.1b	5-15% pa market growth since 2020 50-80% of 2020 market share
Treasury Americas	$1.9b	$2.4b	$160m – $200m EBITS opportunity
Treasury Premium Brands	$0.8b	$1.1b	$70m – $90m EBITS opportunity
DAOU	$0.8b	$1.6b	$70m – $130m EBITS opportunity
Corporate Costs	($0.8b)	($1.0b)	Based on 12 months to June 2023
Net Debt	($1.3b)	($1.3b)	Book value
Franking Credits	$0b	$0b	70% of face value
Equity value*	**$6.6b**	**$13.7b**	
Equity value per share	**$8**	**$17**	

*Numbers may not add up due to rounding

We think the market is underestimating the upside from a removal of Chinese wine tariffs. Partially offsetting this, we are concerned expectations for DAOU and Treasury Americas may be too optimistic.

Source: Merlon Capital Partners.

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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

This material has been prepared by Merlon Capital Partners (ABN 94 140 833 683, AFSL 343753) Merlon, the investment manager of the Merlon Australian Share Income 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.