Merlon Concentrated Australian Share Fund

Quarterly Report – September 2022

For queries, please call Investor Services on 13 51 53

Fund Features

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

Simple Process: We invest in undervalued companies where we think market participants have become too pessimistic.

Concentrated: A portfolio of 25-35 companies constructed without regard to benchmark weights.

True-to-Label Performance: Merlon's investment team has a proven long-term value investing track record since its 2010 inception.

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 manager	Neil Margolis
Fund inception date	1st February 2018
Merlon FUM	$954m
Strategy FUM	$411m
Fund FUM	$108m
Management fee	0.52% p.a
Performance fee	20% of the Fund's daily return above the benchmark
Fund objective	The Fund aims 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	Quarterly
APIR Code	HOW2217AU

Top 10 Holdings (Alphabetical)

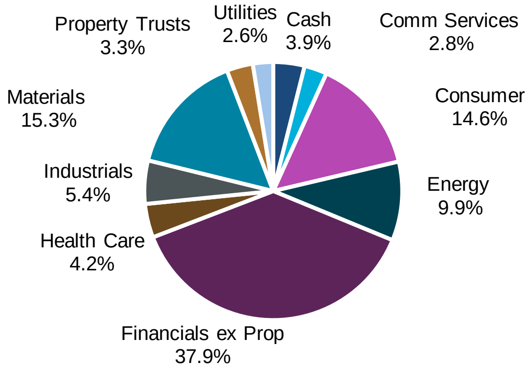
AMP Limited	CSL Limited
ANZ Group Ltd	Insurance Australia Group
BHP Group Limited	QBE Insurance Group
Coles Group Ltd	Westpac Banking Corporation
CBA	Woodside Petroleum Limited

Fund Performance net of all fees and expenses

%[1]	Fund	Benchmark[2]	Excess
Since Inception (p.a)[3]	4.4	5.5	-1.1
5 Years (p.a)	-	-	-
3 Years (p.a)	4.4	2.7	1.7
1 Year	-0.3	-7.7	7.4
FYTD	2.4	0.4	2.1
Quarter	2.4	0.4	2.1
1 Month	-6.3	-6.2	-0.1

[1]Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures. Past performance is not a reliable indicator of future performance.
[2] The Fund benchmark is the S&P/ASX 200 Accumulation Index.
[3]The Inception Date for the fund is 1 February 2018. Strategy Inception date is 31 May 2010.
Source: Fidante Partners Limited, 30 September 2022.

Sector Exposure



Quarterly value added relative to benchmark

Top 5	Value Added (%)
Whitehaven Coal Ltd	1.1
New Hope Corporation Ltd	0.7
AMP Limited	0.3
Insignia Financial Ltd	0.2
Qantas Airways Limited	0.2

Bottom 5	Value Added (%)
Alumina Limited	-0.2
CSL Limited	-0.2
Newcrest Mining Limited	-0.3
Pilbara Minerals Ltd	-0.4
Unibail Group Stalped	-0.4

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

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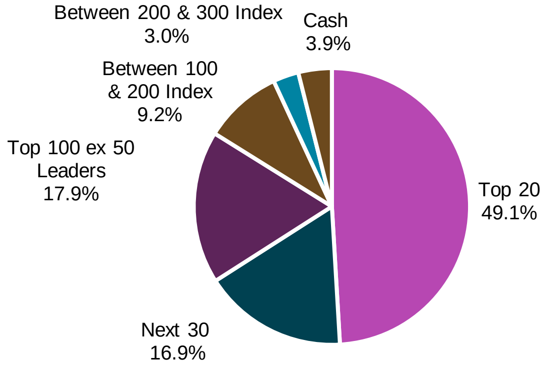
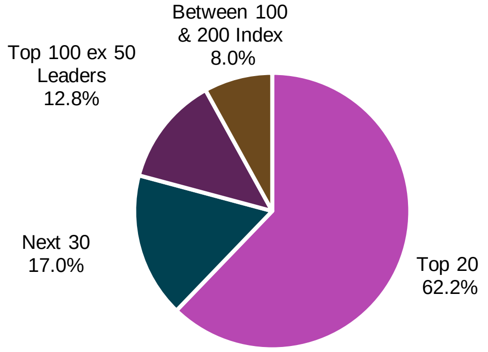
Market Cap Bands - Fund



Market Cap Bands – ASX 200



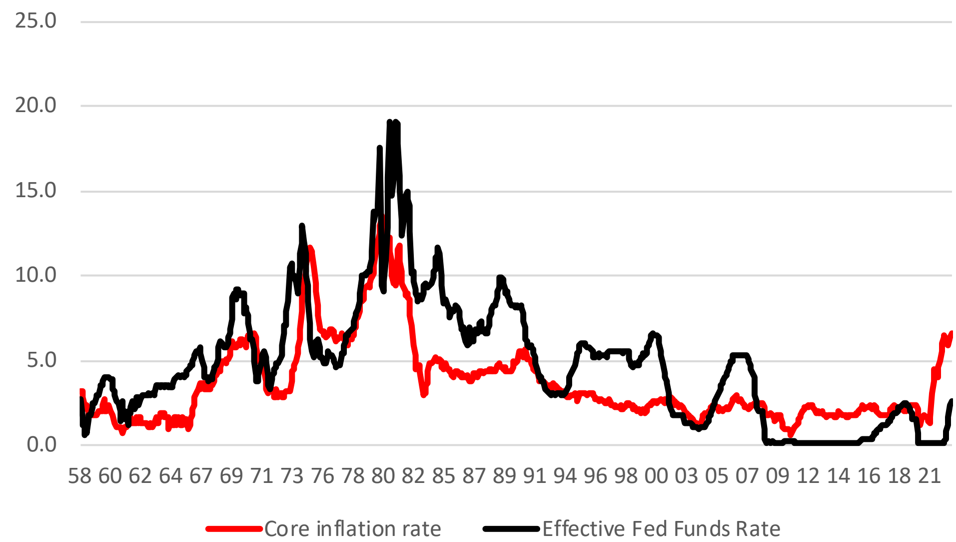
Market Review and Outlook

The Australian market produced a 0.40% return 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.

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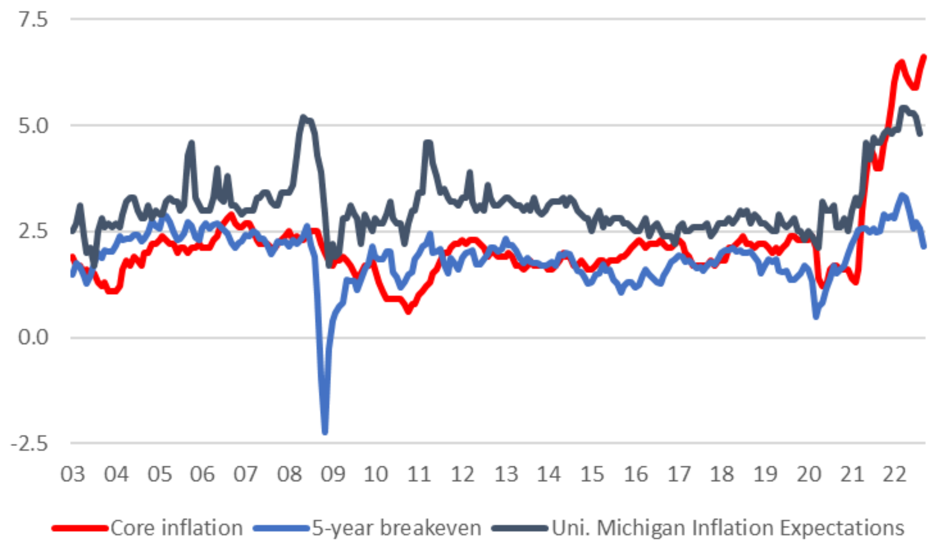
Markets remained focused on the risks of recession, as well as US Mid-Terms and Biden's response to OPEC+ production target cut, as well as China's National Congress, which is expected to see a third term for President Xi. Perhaps more importantly is whether Xi, post confirmation of a third term, moves 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.

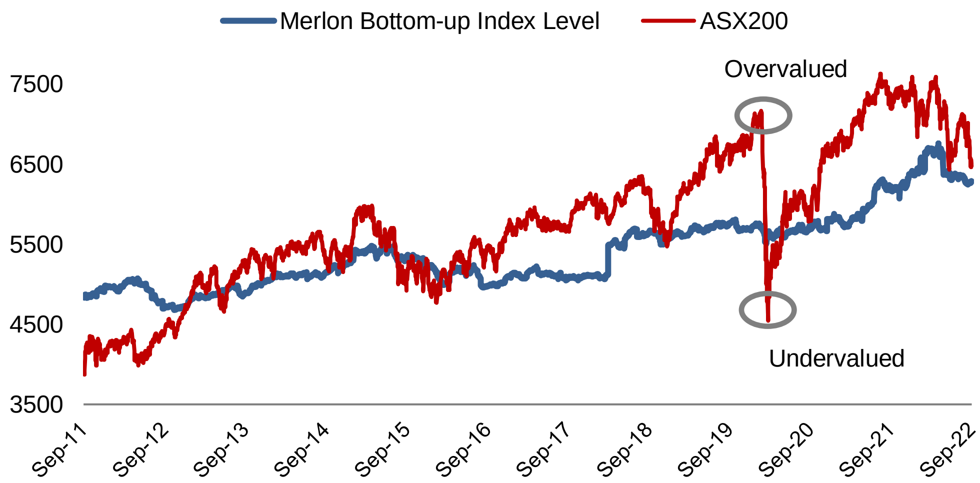
Figure 2: inflation vs inflation expectations (survey & market implied)



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

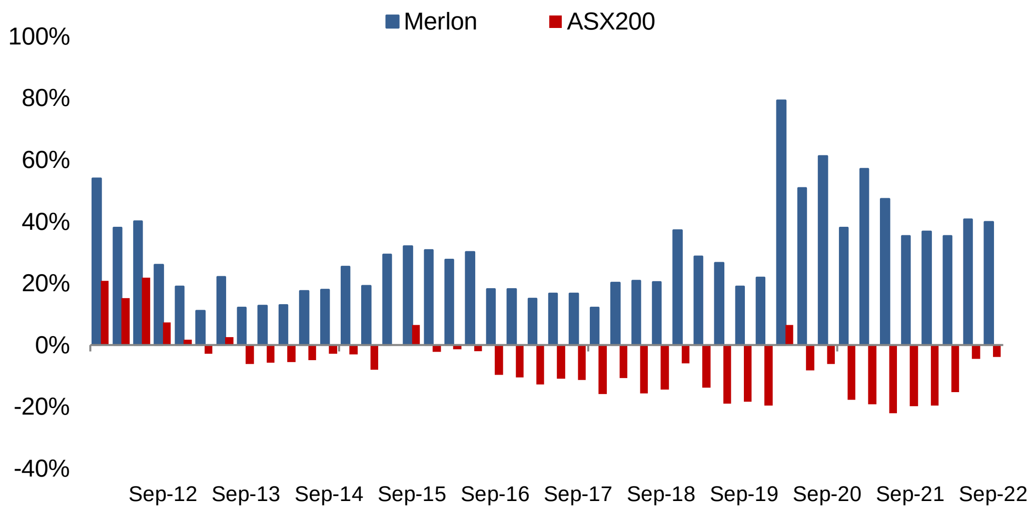


Source: Merlon

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



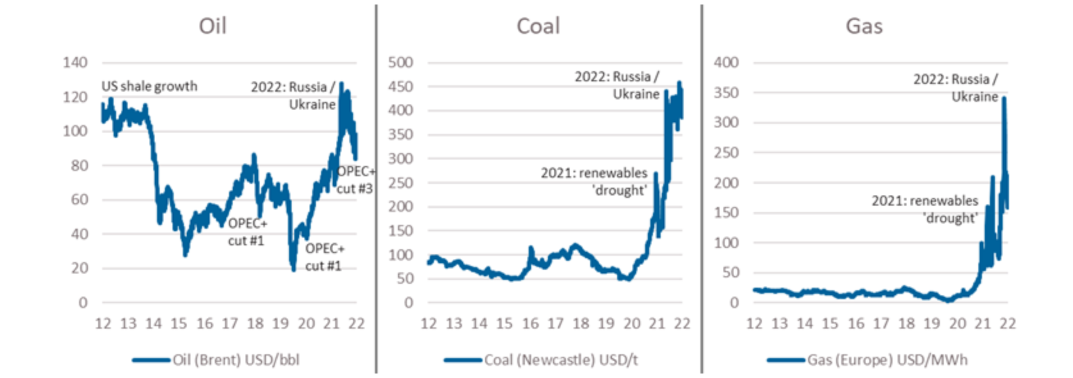
Source: Merlon

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 2: pricing of carbon intensive fuels



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

Portfolio Review

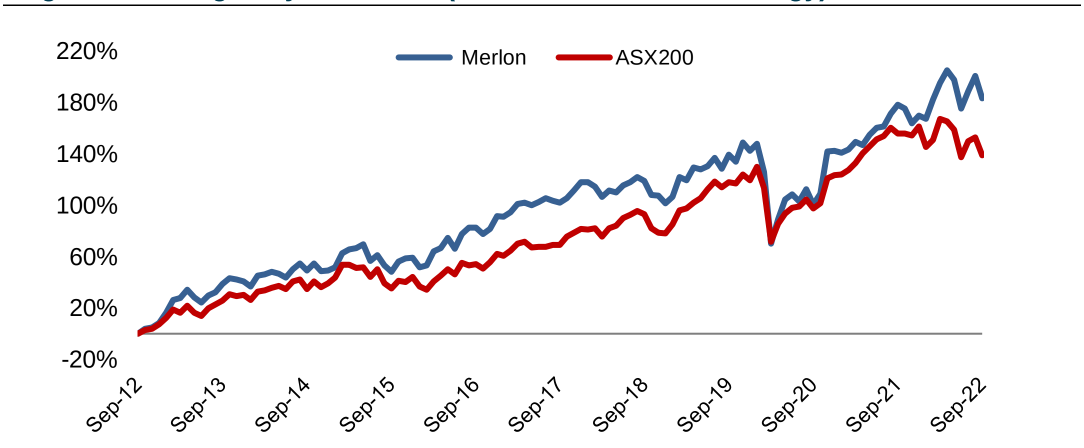
Performance

Quarter: The portfolio outperformed the ASX200 by 2.1% over the quarter. Extending the trends seen in the prior quarter, energy-related companies continued to outperform. While coal related exposures in New Hope Coal and Whitehaven were the top two attributors, while positions in AMP, A2 Milk and Insignia (formerly IOOF) also contributed. 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.

12 months: The portfolio outperformed the ASX200 by 7.4% 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 NAB, as well as overweight exposures in Unibail-Rodamco-Westfield, Alumina and Insignia Financial.

3 years: The portfolio outperformed by 1.7% per annum over the three years to 30 September 2022. Consistent with the more recent periods, this outperformance was led by Whitehaven and New Hope, as well as Ampol, Incitec Pivot and A2 Milk. Woodside also contributed over this period. Detractors over this period were underweight positions in BHP and Commonwealth Bank, and overweight positions in Unibail-Rodamco-Westfield, Southern Cross Media, and AMP.

Figure 5: Rolling ten-year returns (Concentrated Value Strategy)



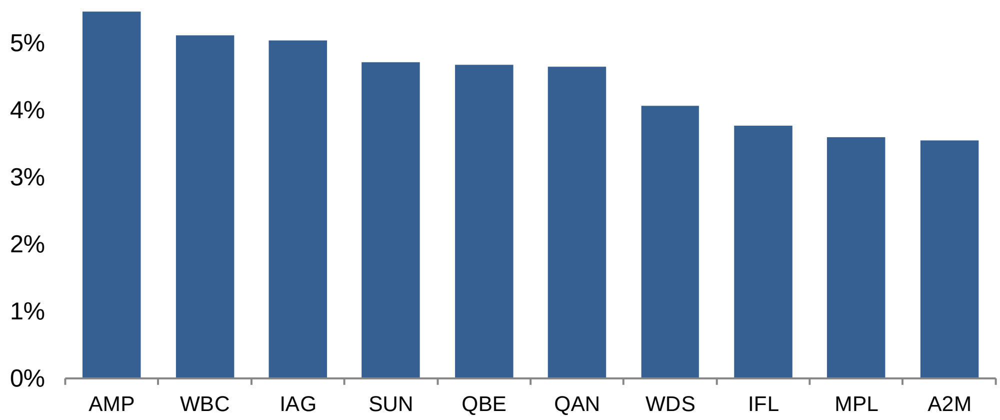
Source: Merlon, returns stated before fees and inclusive of franking credits

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 risks. In the first instance, any such risks are mitigated by our strategy of investing in companies that are under-valued relative to the sustainable free cash flows and the franking credits they generate for their owners. Attractive valuations strongly imply that market concerns are – at least to some extent – already reflected in expectations and provide a “margin of safety” in the event conditions deteriorate.

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 6: Top ten holdings (gross weights)



Source: Merlon

Figure 7: Portfolio Analytics

	Portfolio	ASX200
Number of Equity Positions	35	200
Active Share	80%	0%
Merlon Valuation Upside	46%	-4%
Mid-cycle Free Cash Flow Yield	7.0%	5.1%
EV / EBITDA (year ahead)	12.6x	14.1x
Price / Earnings Ratio (year ahead)	12.0x	15.7x
Price / Book Ratio (year ahead)	1.7x	3.1x

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.

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Portfolio activity and key holdings

New positions were established in Bendigo Bank (provides appealing upside in a strong, but largely overvalued sector) and JB HiFi (valuation upside emerging as the market over-extrapolates the anticipated consumer spending downturn). These positions were funded by the complete exits of Ampol (reached the upper end of our valuation range as the market factored in unsustainably high refining margins) and Virtus (takeover). Significant additions were made to existing positions in AGL and Genworth, while reductions were made to positions in New Hope and Coles.

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.

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

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.

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

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.

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

WDS We have been reducing the exposure to Woodside Petroleum as it has rallied towards our assessment of value, with the market increasingly reflecting the strong cashflow generation that it has previously undervalued. While oil prices had rallied on the global recovery in mobility (excluding China), and the underinvestment in oil supply should further support prices over the medium-term, conditions are becoming increasingly tough for demand, given energy / activity rationing in Europe leading into their winter, and the effects of the US Fed led monetary policy tightening aggressiveness.

IFL Insignia (previously IOOF) is effectively the only remaining scale operator in financial advice. While the market is concerned about competition, fee and regulatory pressures, the company is trading on just 9 x FY22 earnings. The company is generating strong cashflows, which is likely to lead to capital management, having completed its acquisition of MLC, a transaction we see as likely to enable cost out and the extraction of up to $150m of synergies.

MPL We entered MPL with the view the market was overly pessimistic about the future of the health insurance industry in the midst of COVID. The reality was the franchise was in the best health of its life, and that the repayments to policyholders for foregone services would not be onerous. The market has come around to our line of thinking as the PHI market grows at levels not seen since 2015, and the repayments have flowed through to customers via premium increase holidays rather than cash.

A2M is a differentiated infant formula brand with strong competitive position in China and other Asia pacific markets. Market share loss due to COVID disruption of its daigou distribution channel provided an opportunity for Merlon to invest in a high-quality brand with strong growth prospects. Turnaround efforts by new management is beginning to show encouraging signs and we are positive on A2M's future growth and margin upside. Regardless of its upside optionality, A2M's current position is attractive as it currently generates a free cash flow yield of 6% and is backed by $1.3b NZD of cash, franking and equity investments.

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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