Merlon Concentrated Australian Share Fund

Monthly Fact Sheet – December 2023

For queries, please call Investor Services on 1300 721 637

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.

Proven Track Record: Merlon's investment team has a proven track record of delivering true-to-label performance since its 2010 strategy 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 managers	Neil Margolis & Andrew Fraser
Fund inception date	1st February 2018
Merlon FUM	$740m
Strategy FUM	$122m
Fund FUM	$122m
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)

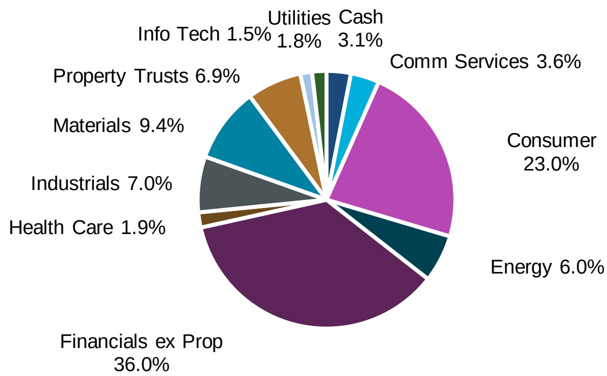
a2 Milk Co	Insurance Australia Group
AMP	QBE Insurance Group
ASX	Santos
Coles Group	Unibail Group
CSR	Westpac Banking Corporation

Fund Performance net of all fees and expenses

%[1]	Fund	Benchmark[2]	Excess
Since Inception (p.a)[3]	7.0	8.0	-1.1
5 Years (p.a)	10.5	10.3	0.2
3 Years (p.a)	11.7	9.3	2.4
1 Year	7.0	12.4	-5.4
FYTD	0.5	7.6	-7.1
6 Months	0.5	7.6	-7.1
Quarter	3.3	8.4	-5.1
1 Month	6.2	7.3	-1.1

[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, 31 December 2023.

Sector Exposure



Quarterly value added relative to benchmark

Top 5	Value Added (%)
Unibail Group	1.5
Woodside Energy	0.7
CSR	0.5
News Corporation	0.3
Helia Group	0.3

Bottom 5	Value Added (%)
QBE Insurance Group	-0.6
Treasury Wine Estates	-0.6
BHP Group	-0.6
Star Entertainment	-0.7
AMP	-1.7

Source: Fidante Partners Limited, 31 December 2023. Benchmark is S&P/ASX 200 Accumulation Index

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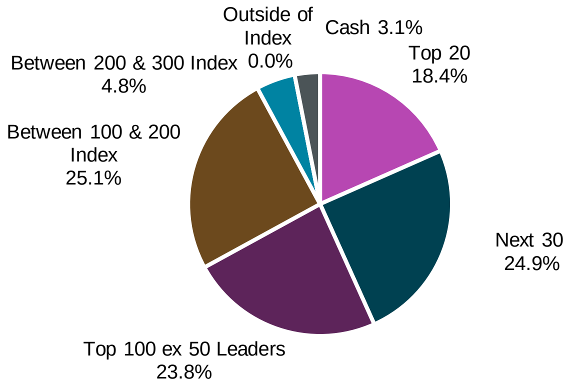
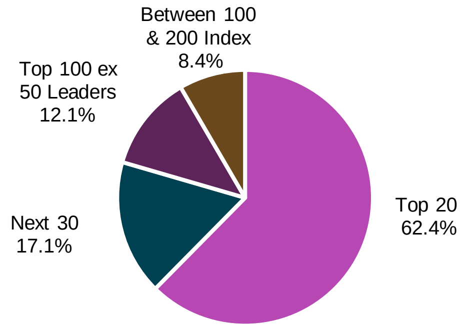
Market Cap Bands - Fund



Market Cap Bands – ASX 200



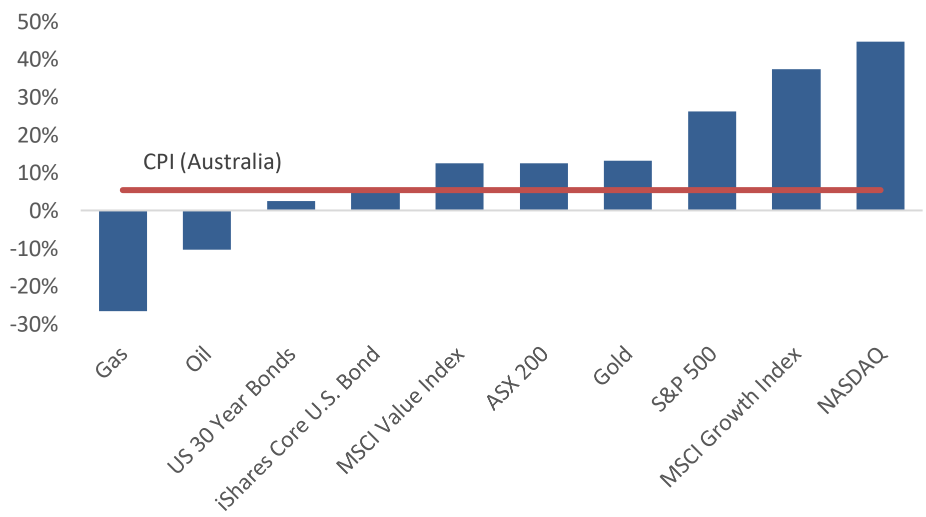
Market Review (2023) – Goldilocks returns

US 10-year bond yields ended the year where they started at 3.9%, but this masks an extraordinary bond rally into year-end after yields peaked at 5.0% in October (and the US mortgage rate at 7.8%). Long-term inflation expectations remained anchored in the low 2s for the entire year but did reduce from 2.5% in October to 2.2% at year-end.

"Goldilocks" was in full force with the deceleration in core inflation occurring despite US unemployment ending the year at 3.7%, only 0.2% above where it started and a mere 0.3% above the January print which was the lowest since 1969. Australian unemployment rose 0.4% to 3.9% over the year, a remarkably good outcome given the 4.25% increase in the RBA cash rate since April 2022.

Equities proved way more efficient than bonds, with the S&P500 and NASDAQ already up 12.9% and 26.8% respectively when bond yields hit 5% and 30-year bonds had lost 14.7% of their value. In the end, it was hard to lose money in 2023 unless you were long oil and gas. However, real returns were more muted outside of long duration growth stocks.

Figure 1: Asset Class Returns Calendar Year 2023



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 at the start of the year, **Insurance**, tracking lower claims and higher rates, **Materials**, with iron ore rallying 20% despite copper only +1%, and **REITs**, albeit most of the gains in the last quarter. The worst performing sectors over the year were **Consumer Staples**, **Healthcare** and **Utilities**, all partly reflecting high premiums paid for defensiveness at the start of the year, **Energy** (as oil tumbled 10%) and **Diversified Financials**. Small caps underperformed large caps by a sizeable 4.8%, while within the top 100, the top 20 materially outperformed mid-caps by 5.9%.

The iron ore miners outperformed over the year, with short-dated prices rising by 20% as noted above, while long-dated prices were up 2%. The Chinese property market continued to worsen, with the world's two largest developers defaulting on their borrowings, and property sales remaining negative, resulting in market expectations of a large-scale Chinese stimulus package growing.

Portfolio Review (2023)

The Merlon concentrated portfolio increased by **7.0%** in 2023 (before 1.2% in franking credits) but lagged the market's **12.4%** return, underperforming by **5.4%**.

Although returns were still positive and 2023 follows **21.3%** outperformance in 2022, it was nonetheless a disappointing year reflecting a shift from overly pessimistic inflation expectations back to what appears to be complacency, as well as stock specific issues. With regard to inflation and rates, we continue to focus on bottom-up free cash flow that is being under-appreciated by the market rather than adjusting discount rates for stocks with lower perceived risk or longer perceived growth expectations. Nevertheless, declining inflation and interest rate expectations in the back half of the year disproportionately benefitted stocks with longer dated growth expectations that typically don't screen as well in our process.

Despite the challenging year in a relative sense, we remain confident our "behavioural bias" philosophy –

"We believe people are motivated by short-term outcomes, overemphasise recent information and are uncomfortable having unpopular views"

– and disciplined process –

"We invest in undervalued companies where we think market participants have become too pessimistic."

will continue to deliver excess returns to investors.

Other themes that impacted the portfolio over the year, which is constructed without regard to benchmark weights and typically has a mid-cap bias, included the outperformance of ultra-large caps (top 20 outperformed mid-caps by 5.9%) and the outperformance of iron ore stocks, which comprise 16% of the index and detracted 1.6% from relative performance.

We also acknowledge stock specific mistakes during the year, with the largest detractors being **A2 Milk**, with earnings impacted by collapsing but unsustainably low Chinese birth rates; **AMP** with frustratingly slow capital returns pending regulatory approval and the bank being exposed to intense industry competition which should subside; **Alumina**, with mine specific environmental delays and depressed alumina prices (albeit some positive cost reduction news post year-end); **Star Entertainment Group**, where we under-estimated the impact of tighter regulatory restrictions on near-term Sydney casino earnings even though we only invested after the market capitalisation declined 70% in two years, and **IOOF Holdings** where outflows persists, margins remain under pressure and the CEO made a surprise exit, however the shares are now trading below our bear case valuation.

In contrast, we got several things right, including exiting coal mining stocks and most of our energy holdings when commodity prices were far higher. The top 5 contributors included investing in **AGL Energy** near its lows before electricity prices improved; retaining our investment in **Unibail-Rodamco-Westfield** with the market implying a steep discount to the value of its high-quality malls that are experiencing solid rent growth; investing in **CSR Limited** when building activity expectations were overly pessimistic and housing starts have proven more resilient; **Helia Group** (formerly Genworth) where the market was too pessimistic about the likelihood of a house price collapse; and **Newscorp**, which outperformed in tandem with its key investment REA Group, along with its growing Dow Jones subscription business. Not owing **CSL** also benefitted relative performance.

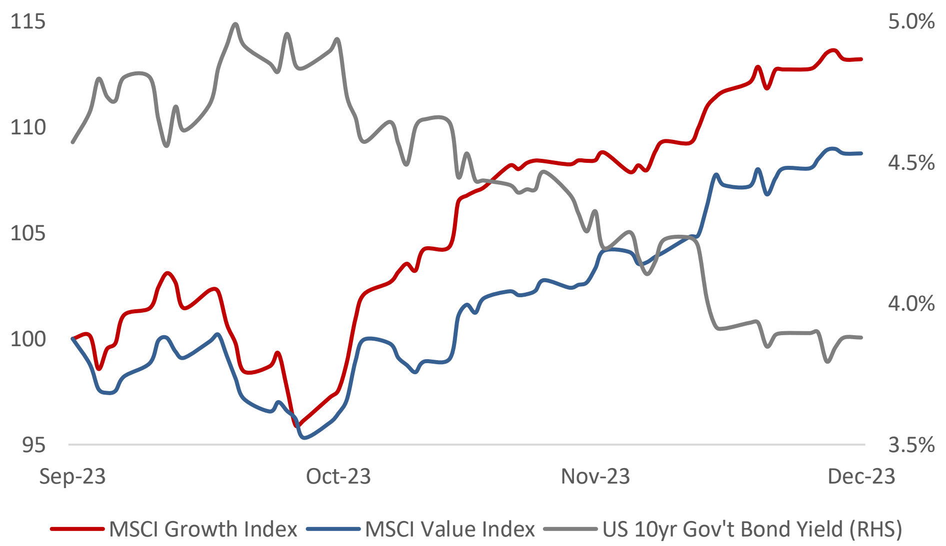
Market Review (December 2023 quarter)

Markets rallied during the December quarter, as they have done throughout the calendar year. As noted in our annual review above, equity markets pretty much priced in the deceleration of inflation long before bond yields peaked in October. The December quarter saw US Treasury yields almost entirely reverse the September quarter's yield spike, as markets moved to price in not only a peak in yields, but certainty around the potential for outright cuts to official rates. With Australian inflation and rates somewhat lagging the US, the Australian Dollar gained 5.9% in the quarter to finish the year unchanged.

With this supportive backdrop, we saw equity markets rally strongly, driven by **REITs** and **Healthcare**, both tracking bond prices higher, **Materials**, with iron ore rallying 17% despite copper only 3%, **Banks**, with recession fears easing, and **Diversified Financials**, tracking markets higher. The weakest sector in the quarter included **Energy**, with Brent oil -19% and longer-dated prices -8%, **Utilities**, tracking gas and wholesale electricity prices lower, **Insurance**, impacted by falling bond yields and more storms late in the quarter, and **Consumer Staples**.

As can be seen in Figure 2, the collapse in bond yields favoured stocks with longer-dated growth expectations that typically screen less favourably in our process that seeks to investment in undervalued companies where we think market participants have become too pessimistic.

Figure 2: Global growth and value index performance vs US 10 year bond yields



Source: Merlon Capital Partners, Bloomberg

Portfolio Review (December 2023 quarter)

The Merlon concentrated portfolio returned **3.3%** in the quarter (before franking credits) compared to **8.4%** for the market, representing **5.1%** underperformance.

As noted in the 12-month performance review and highlighted in Figure 2 above, the period reflected a shift to lower interest rate and inflation expectations which disproportionately benefitted bond-proxy stocks and those with longer dated growth expectations. In addition, the portfolio's mid-cap bias was a headwind in a relative sense with the top 20 outperforming midcaps by 4.9% in the quarter. In addition to banks outperforming, the large cap iron ore stocks rallied strongly alongside the iron price and detracted from relative returns.

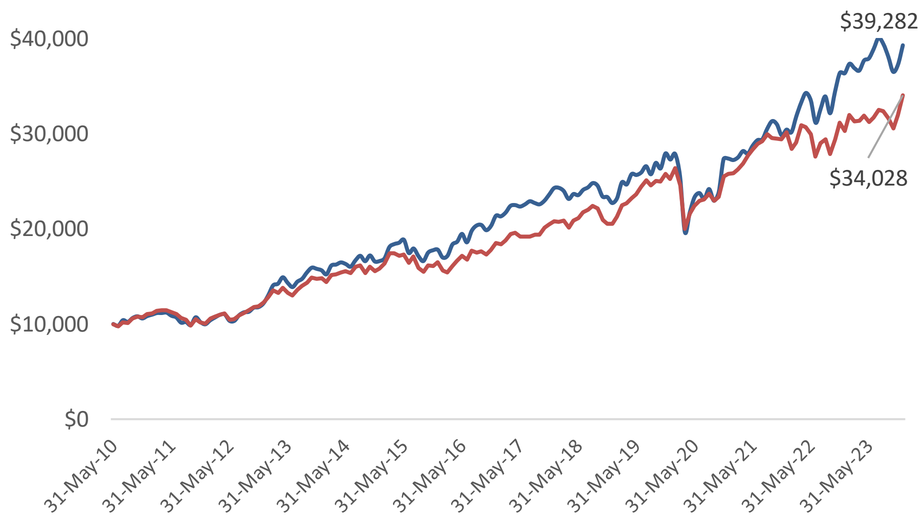
In terms of stock specific detractors, **AMP** detracted the most with frustratingly slow capital returns and AMP Bank being exposed to intense industry competition which we believe should subside; **Star Entertainment Group** following a capital raising to reduce debt, ongoing construction delays with the Brisbane casino complex and near-term Sydney earnings remaining under pressure due to restrictive regulatory settings and softer economic conditions; **Treasury Wine Group**, following a surprise overpriced US acquisition that more than offset positive news on the likely ending of punitive Chinese wine tariffs; **QBE Insurance** with falling bond yields seen as detracting from earnings upside that had been priced in; and not owing **BHP** detracted with the iron ore price rallying strongly notwithstanding weak economic conditions in China.

In contrast, top performers over the quarter included **Unibail-Rodamco-Westfield** with positive operating trends in its shopping malls and the market less concerned about refinancing debt given its lengthy maturity and low cost; exiting **Woodside** before the oil price declined and the shares underperformed; **CSR** which delivered earnings well ahead of consensus based on the backlog of activity; **Newscorp**, which outperformed in tandem with its key investment REA Group, along with strong growth from its Dow Jones subscription business; and **Helia Group** (formerly Genworth) with low claims costs against overly pessimistic market expectations.

Longer Term

Over the past 3, 5 and 10 years, the Merlon Concentrated Share strategy has outperformed the ASX200, before fees, by **3.8%**, **1.3%** and **1.2%** per annum respectively. In addition, there have been excess franking credits over the ASX200 of 0.1% per annum over 10 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.

Figure 3: Value of $10k since inception (Concentrated Value Strategy)



Source: Merlon Capital Partners, Merlon Concentrated Value Strategy returns stated before fees and inclusive of franking credits

Portfolio Activity

During the quarter we initiated a new investment in **Endeavour Group** (see Stock in Focus), along with re-initiating a small investment in **Woodside Petroleum** after both the oil and share price declined following our exit in the first half of 2023. Valuation appeal and upside risk bias to the oil price have since re-emerged.

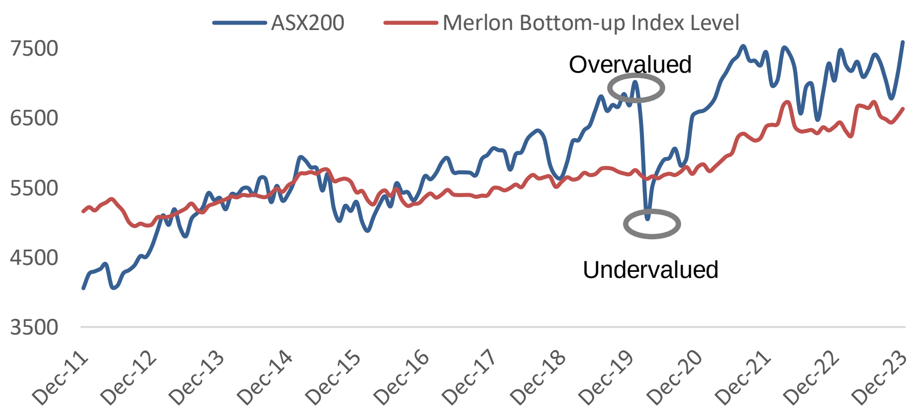
Other buying activity related to topping up existing positions, including the **Australian Stock Exchange**, **Fletcher Building**, **ANZ Bank**, **Dexus** and **A2 Milk**, all of which exhibited increased valuation appeal and conviction following ongoing engagement with the companies and industry experts.

These additions were funded by a complete exit in **Janus Henderson**, the UK-based fund manager that de-listed from the ASX, **Viva Energy** and **Downer Group**, where we changed our Downer Group investment view after making an initial investment the prior quarter but reducing our valuation and conviction after formally engaging with the company. We also reduced but retained investments in companies that had outperformed and therefore had reduced upside, including **Medibank**, **Newscorp**, **Helia Group**, **Unibail-Rodamco-Westifield** and **AGL Energy**. We also reduced our investment in **Treasury Group** after the disappointing US acquisition which we view as overpriced based on the limited financial information available.

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



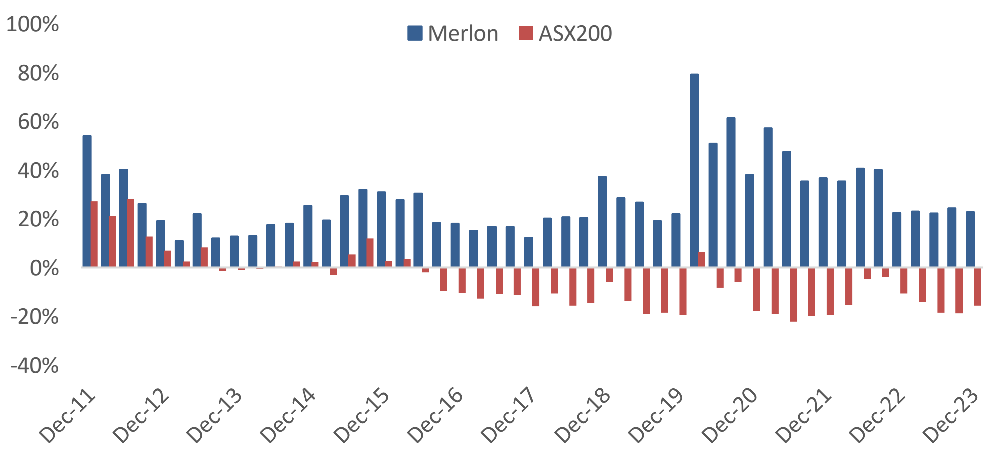
Source: Merlon Capital Partners

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



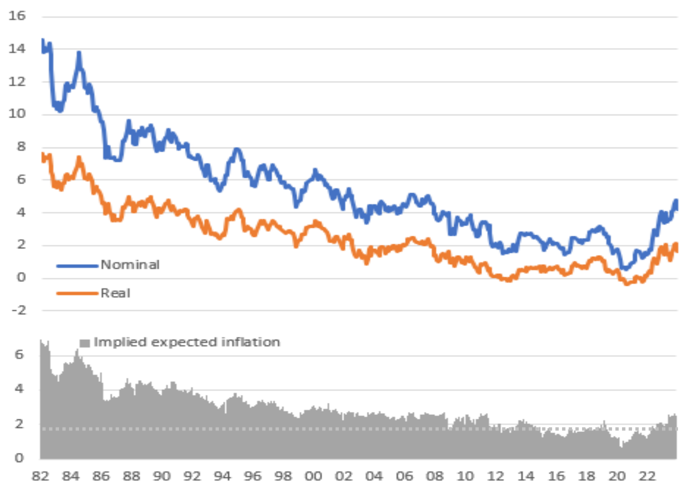
Source: Merlon Capital Partners

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.

The impact of taming inflation

While the 2023 rise in yields was driven by growing market expectations of official rates at least peaking, the steepness of the end of year rally has come amidst Federal Reserve signalling that the potential for rate cuts had 'come into view'. If 2023 represents the peak of this rates cycle, it would have done so at a 15- year high, the point preceding the GFC.

Figure 6: US 10-year treasury yield – nominal vs real



Source: Federal Reserve Bank of St. Louis

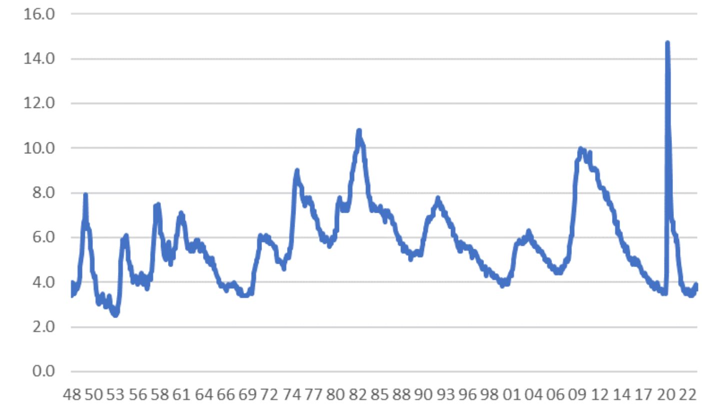
This rate cycle has seen the yield curve's inversion (shorter dated bond yields moving higher than longer dated bond yields) indicating a raised prospect of recession. To the extent that relative yields are a lead indicator, markets appear happy to see their peak as a signal as easier prospects ahead, regardless of shorter-term recession risks.

Figure 7: US 10-year minus 2-year treasury bond yield

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 8: US Unemployment Rate



Source: Federal Reserve Bank of St. Louis

As noted previously, observing the history of inflationary periods demonstrates that if it is not sufficiently controlled at its outset, there is a risk of multiple subsequent inflationary and unemployment waves. These phases can also prove beyond the control of central banks, as seen historically through periods of instability in large energy producing regions of the world including Russia and the Middle East.

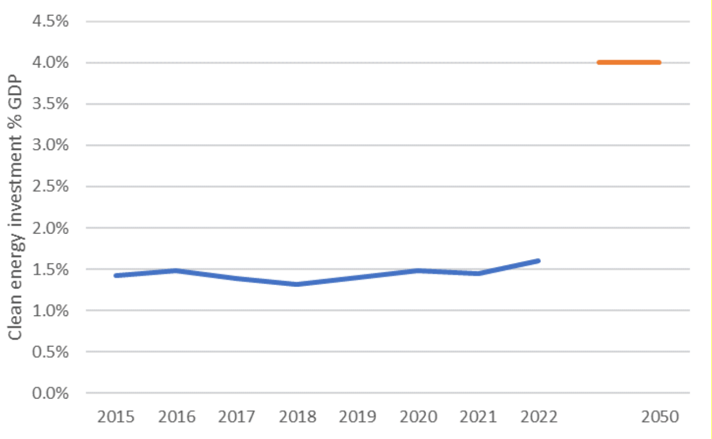
However, following the energy spikes associated with COVID supply disruptions, Russia's invasion of Ukraine, and more recently re-escalation of tensions in the Middle East, energy prices have remained at levels well below peaks and in line with historical averages. This reduced inflationary impulse is, at least in part, an indicator for central banks to be more confident in a victory over inflation, with considerations turning back towards the declining rate trend of the past thirty-plus years.

Figure 9: Global Price of Energy Index (real terms)

Source: International Monetary Fund. Federal Reserve Bank of St. Louis

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 10: 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.

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.

Figure 11: Portfolio Analytics

	Portfolio	ASX200
Number of Equity Positions	32	200
Active Share	82%	0%
Merlon Valuation Upside	28%	-16%
Price / Earnings Ratio (year ahead)	16.2x	18.1x

*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.*

Stock in Focus

Endeavour Group (EDV) operates Australia's largest retail drinks retail network under the Dan Murphy's and BWS Brands along with the largest network of over 350 licenced hotels, employing ~28,000 people.

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 EDV at between $4.90/share and $6.20/share based on long-term assumptions and segment valuations:

The shares have underperformed since being spun out of Woolworths in 2021 on account of regulatory risk related to poker machines in its hotel network as well as a "Covid hangover" and sluggish operating trends in its retail drinks business.

In terms of regulatory risk, we acquired the shares when trading at our low case valuation which already incorporates a $1 billion haircut based on 40% of the segment's earnings being regulated away over time. In practice, reforms are likely to be more incremental given state government reliance on taxes and independent operators facing greater difficulty implementing changes.

In terms of the retail drinks business, Dan Murphy's is an exceptional franchise with more than double the market share of its nearest competitor and our view is the recent share loss is reflective of ceding early gains during Covid rather than structural concerns. We also believe capital expenditure can be optimised and returns can be improved.

Figure 12: Extract of letter to EDV Board

14 December 2023

Members of the Board of Directors
Endeavour Group
26 Waterloo Street
Surry Hills NSW 2010

Re: Introduction to Merlon Capital Partners

Ladies and Gentlemen:

For your records, Merlon Capital Partners ("Merlon" or "we") owns 2,751,908 shares in Endeavour Group ("EDV" 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 EDV 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 EDV.

Key ESG Issues in Relation to EDV
Consistent with our investment approach, Merlon actively engages with market participants including other fund managers, proxy advisors, brokers and external rating agencies as well as other relevant stakeholders to identify market views and concerns regarding a company's ESG exposure and performance. In such discussions, key ESG issues identified in relation to EDV include:

1. Personal and social harm caused by gaming machines: some ESG analysts and fund managers have blacklisted the gambling industry due to the addictive nature of gaming machines, making it highly likely to cause personal and social harm. We similarly believe that gaming machines have the potential to cause harm, which can only be managed with strong policies that are rigorously enforced by a diligent management team and Board.

Segment	Low	High	Key Assumptions
Retail	$8.2bn	$8.8bn	EBITDA margin 9.2-9.8%, capitalised at 9.0x
Hotels	$3.8bn	$4.1bn	EBITDA margin 35-37%, capitalised at 5.5x
Harm reduction initiatives	($1.0bn)	($0.1bn)	40-60% of Gaming earnings from problem gamblers, 10-90% initiative effectiveness
Corporate costs	($0.6bn)	($0.6bn)	Jun-23 capitalised at 9.0x
Net Debt	($1.7bn)	($1.7bn)	Jun-23 balance adjusted for working capital
Franking Credits	NIL	$0.6bn	0-70% of face value
Equity value*	**$8.8bn**	**$11.1bn**	
Equity value per share	**$4.90**	**$6.20**	

*Numbers may not add up due to rounding

While we acknowledge EDV faces a permanent diminution in earnings power in the Hotels business associated with rising social and political concerns about money laundering and problem gambling, we think current market expectations are too pessimistic. Further, we think concerns about the performance of the Retail business can be addressed, capital expenditure can be optimised and returns can be improved.

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