Merlon Concentrated Australian Share Fund

Quarterly Report – March 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	$1,086m
Strategy FUM	$468m
Fund FUM	$3m
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 over rolling three-year periods measured as a total return inclusive of franking credits.
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)

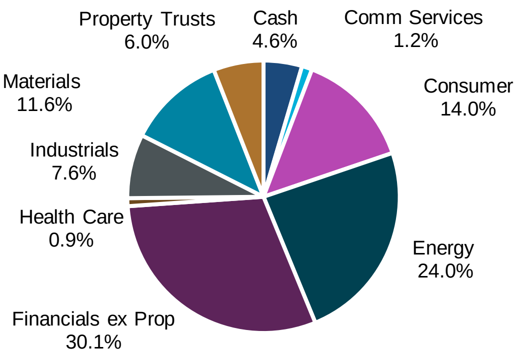
Alumina Limited	QBE Insurance Group Limited
Ampol Ltd	Santos Limited
Coles Group Ltd	Suncorp Group
Insurance Australia Group	Westpac Banking Corporation
Newcrest Mining Limited	Woodside Petroleum Limited

Fund Performance net of all fees and expenses

%[1]	Fund	Benchmark[2]	Excess
Since Inception (p.a)[3]	7.8	10.8	-2.9
5 Years (p.a)	-	-	-
3 Years (p.a)	10.8	11.8	-1.0
1 Year	19.7	16.4	3.3
FYTD	14.5	7.4	7.1
Quarter	10.2	2.8	7.4
1 Month	5.4	7.0	-1.6

[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 benchmark is the S&P/ASX 200 Accumulation Index (inclusive of franking credits).
[3]The Inception Date for the fund is 1 February 2018. Strategy Inception date is 31 May 2010.
Source: Fidante Partners Limited, 31 March 2022.

Sector Exposure



Quarterly value added relative to benchmark

Top 5	Value Added (%)
Woodside Petroleum Limited	1.8
New Hope Corporation Ltd	1.0
Whitehaven Coal Ltd	0.9
Santos Limited	0.8
Origin Energy Limited	0.8

Bottom 5	Value Added (%)
Commonwealth Bank of Australia	-0.4
Rio Tinto Limited	-0.4
National Australia Bank Limited	-0.4
Super Retail Group Limited	-0.6
BHP Group Limited	-2.0

Source: Fidante Partners Limited, 31 March 2022. Benchmark is S&P/ASX 200 Accumulation Index (inclusive of franking credits)

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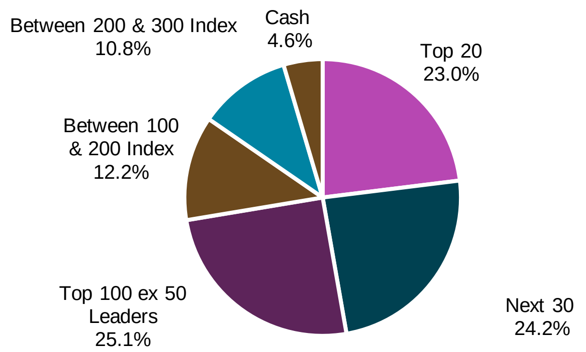
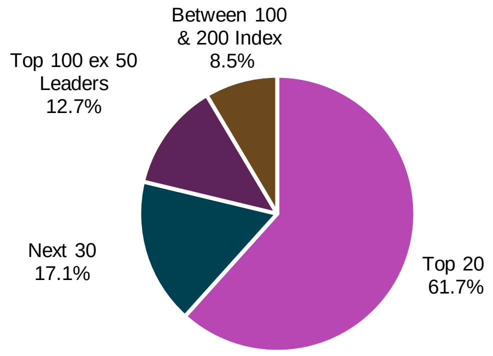
Market Cap Bands - Fund



Market Cap Bands – ASX 200



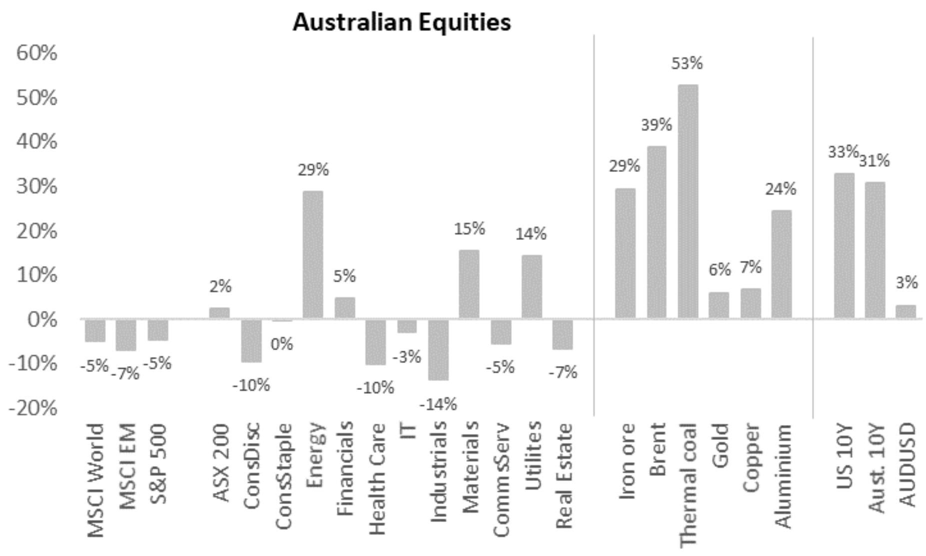
Market Review and Outlook

The Australian market returned 2% for the quarter, well ahead of global markets which lost 5%. The relatively strong quarter by the Australian market was driven by the Energy sector, following Russia's invasion of Ukraine, and subsequent announcements of sanctions of Russia's energy-heavy export sector. Strong returns were also seen in the Materials and Utilities sectors.

The oil price rallied more than 50% in 2021 yet the domestic Energy sector recorded a -2% return over the same period. Pleasingly, it in part made of up for this commodity-relative underperformance with a 29% return in the first quarter of the 2022 calendar year. This has seen the large valuation discount noted in our last quarterly report (see article) narrow somewhat.

US treasury yields rallied alongside implied long-term inflation rates, ensuring real yields remained at negative levels. Real yields ended the quarter at -0.51%, albeit above the -1% level where they ended 2021. As noted, in our prior report, the US Federal Reserve (Fed) has indicated that it is to begin tapering. History has shown this to be difficult, so we watch this attempt with interest.

Figure 1: Overview of key markets



Data source: Bloomberg, Merlon Capital. Inflation measured as the 10-year break even rate.

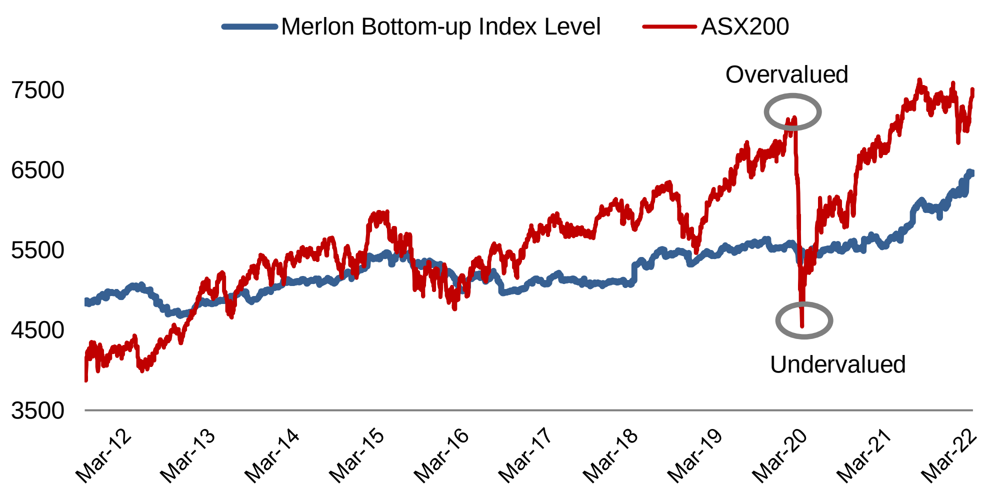
Despite a surging COVID-19 Omicron variant, which peaked at more than four million cases in January, the world's attention was drawn to Russia's 'special operation' in Ukraine. The market's desire for sanctions on Russian energy exports has been thwarted by Europe's dependence on this energy so far.

From a macroeconomic standpoint, the impact on energy and food prices has seen central banks become more hawkish on policy settings. From the charts below, we can see that Fed policy may be at risk of losing control of treasury yields, driven in part by an overshooting of inflation. A quick resolution to the Russian / Ukraine conflict, combined with a post-COVID logistics easing may see inflation as transitory. A more bearish perspective would be a wage-price spiral leading to a more aggressive central bank policy on inflation, in turn driving global economic activity lower. In our view, markets appear to be pricing inflation as "transitory" which poses downside risk if it turns out differently.

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. On this basis the market appears around 20% overvalued after advancing another 3% during the quarter.

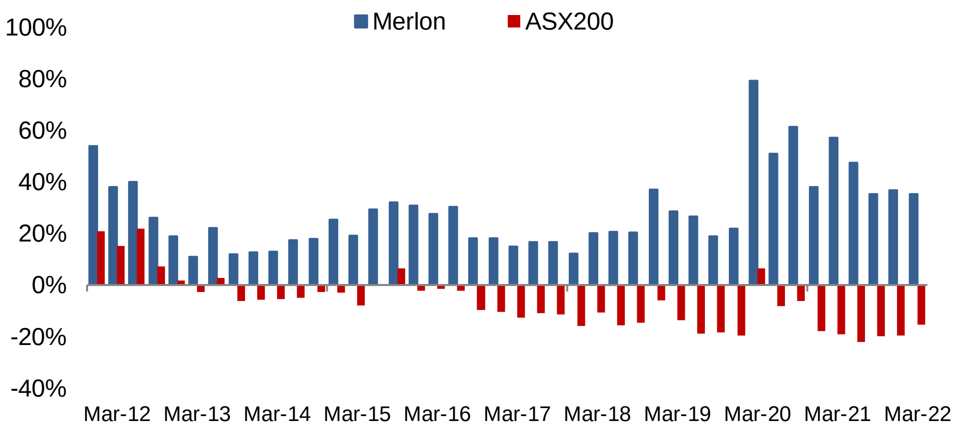
Furthermore, Merlon's focus on near-term cashflows rather than of long-dated growth potential may perform better in comparison to the broader market.

Figure 2: Merlon bottom up market valuation vs ASX200 level



Source: Merlon Capital Partners

Figure 3: Expected return based on Merlon valuations



Source: Merlon Capital Partners

Portfolio Review

At a stock level, the key contributors to the portfolio during the **quarter** were **Woodside Petroleum**, **New Hope Coal**, **Whitehaven Coal**, **Santos**, and **Origin Energy**. Partly offsetting these contributions were underweight positions in **BHP**, **NAB**, **CBA** and **Rio Tinto**, and an overweight position in **Super Cheap Retail**.

Figure 5: Portfolio Analytics

	Portfolio	ASX200
Number of Equity Positions	30	200
Active Share	83%	0%
Merlon Valuation Upside	37%	-15%
Mid-cycle Free Cash Flow Yield	7.4%	5.1%
EV / EBITDA (year ahead)	12.5x	16.0x
Price / Earnings Ratio (year ahead)	12.9x	18.5x
Price / Book Ratio (year ahead)	1.9x	3.8x

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.

Top Holdings (Alphabetical)

The position in **Alumina Limited** was established during the second half of 2020, with COVID-19 related market concerns providing attractive entry points for investment. While the stock has been impacted by the effect of COVID-19 on demand, as well as continued growth in Chinese alumina refining capacity, we expect Alumina's low-cost position to enable it to prevail relative to higher cost peers. Also, we expect China's capacity growth to rationalise and global fiscal stimulus to drive a recovery in demand for aluminium and its alumina-input. The market for alumina has tightened as Noble Group's Jamalco refinery fire in August impacted the supply of alumina, while a military coup in Guinea, the world's largest supplier of bauxite (the feedstock for alumina refining), further destabilised the market.

Ampol is Australia's largest integrated oil refining, fuel distribution and marketing company, operating in a strong industry structure dominated by vertically integrated companies. Volumes have been impacted by COVID-19 related disruptions, yet the company remains in a strong position to maintain and potentially grow share as the incentive for independent, non-integrated retail suppliers to enter the market is declining in anticipation of growth in electric vehicles. Operators who own / control their sites remain in a strong position to increase their convenience offering, while extracting strong conventional fuel margins given the long term need for supply of fuels to non-EV drivers. While the market continues to value the company's refining business as a high-risk asset, the Government's underwriting of refining margins has significantly reduced this risk. Ampol's counter-cyclical, cashflow-accretive takeover of Z Energy (ZEL), increases the company's regional market share - and hence buying power – and supply chain infrastructure utilisation.

Coles remains attractively priced relative to other "defensive" sectors that are included in the "bond proxy" group. Coles and Woolworths operate under an umbrella of a sound industry structure, provide long term inflation protection, have minimal debt and are still generating margins below historic levels despite the COVID demand boost.

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.

Newcrest Mining is one of the world's largest gold mining companies. Against the backdrop of a more extended volatile and extended recovery period coupled with further monetary and fiscal stimulus we believe the risk bias in the gold price is positive. While we expect the US Federal Reserve to attempt to taper its Quantitative Easing programme, a negative for gold in the context of higher real yields, we believe the extent to which it can do so will be limited by 1. The potential global wealth effects of asset price declines and 2. Extensive debt levels globally. In this context, we expect Newcrest to generate strong cash flows, benefiting from its position of far longer dated reserves than those presented by peers.

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.

Having merged with **Oil Search**, a company the portfolio previously owned, **Santos** is now a top-ten position in the portfolio. We voted against the merger as we assessed it as having undervalued Oil Search, a view backed by the Independent Expert's valuation. Despite this, we believe Santos is undervalued by the market, albeit less than Oil Search was, as the consolidation of PNG exposures is likely to enable a smoother path to commercialising the undeveloped Papua LNG project. We also expect the company to reassess the less compelling Alaska project, previously pursued by Oil Search. Like with Woodside, we expect oil prices to continue to strengthen as demand recovers to pre-COVID levels, while the underinvestment in conventional and now unconventional oil supply should further support prices over the medium-term. As with Woodside, the pricing environment for determining new projects is strengthening.

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.

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Westpac is undervalued with the market assuming returns are structurally lower as a result of lower interest rates and 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.

Woodside Petroleum remains undervalued relative to our assessment of value, and despite the rally in oil prices. The market is currently discounting the value of Woodside's cash-generative operating asset base, in addition to its very large contingent reserve profile. We expect oil prices to continue to strengthen as demand recovers to pre-COVID levels, while the underinvestment in conventional and now unconventional oil supply should further support prices over the medium-term, regardless of a transition to renewable energy generation. While the proposed BHP Petroleum merger is roughly neutral to our valuation and conviction, it intelligently provides access to capital to develop its Scarborough project, amidst what is an increasingly favourable contract-pricing environment.

Links to Previous Research

- 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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