

Merlon Australian Share Income Fund

Webinar – 30 January 2020

Neil Margolis and Ben Goodwin

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How Merlon's Approach is Different

Fundamental Research

*Focused on
sustainable cash flow*

Portfolio Diversification

*No reference to
ASX200 weights*

Downside Protection

*Through research &
hedge overlay*

This focus on capital preservation and growth delivers

Sustainable Income

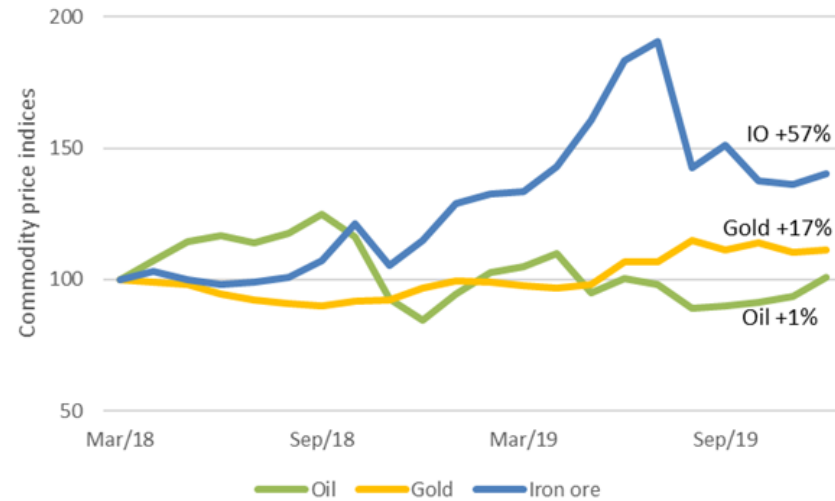
Paid monthly and majority franked

Outline

- ☐ Trade war & commodities
- ☐ Fund positioning and performance

Trade war & commodities

Impact on commodity prices



Source: Bloomberg, Calculations: Merlon Capital Partners January 2020

Summary

1. Trade war risks appear to be easing
2. Longer-term commodity dynamics are unchanged
3. Gold has benefited from US Federal Reserve 'rate cushion'
4. Oil has been flat but price support to come from capital discipline
5. Iron ore prices elevated but underlying demand conditions worsening

Trade war & commodities

Impact on global trade



Source: United Nations Conference on Trade and Development, Calculations: Merlon Capital Partners January 2020

Comments:

- Global trade volumes clearly impacted
- Commodity price impact varied
- Gold and oil most directly impacted

Trade war & commodities

A longer term perspective



Source: United Nations Conference on Trade and Development, Calculations: Merlon Capital Partners January 2020

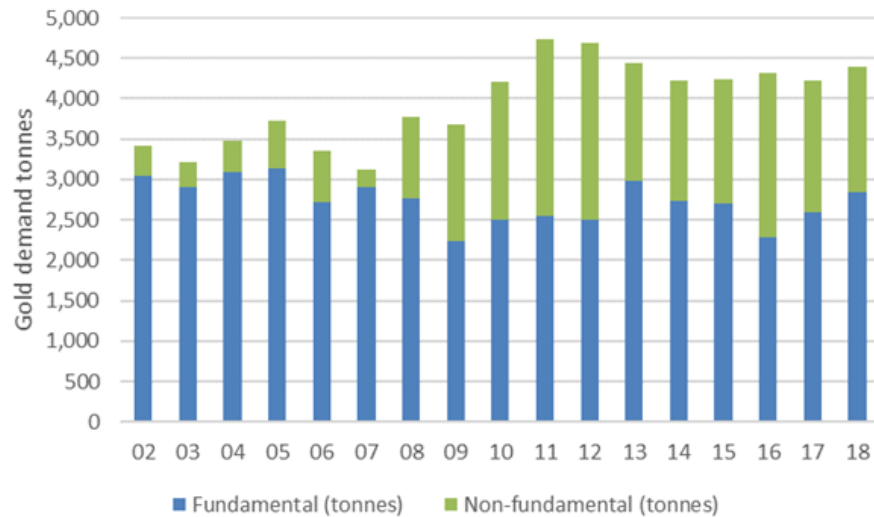
Comments:

- We look for situations where pricing is unsustainably low
- Gold and iron ore are both at apparently unsustainable levels
- Oil shows pricing that is in line with normal levels

Trade war & commodities: gold

- **Trade war impact:** +17%, driven by Fed policy & uncertainty
- **Longer term outlook:** trading 72% above long term averages

Non-fundamental demand



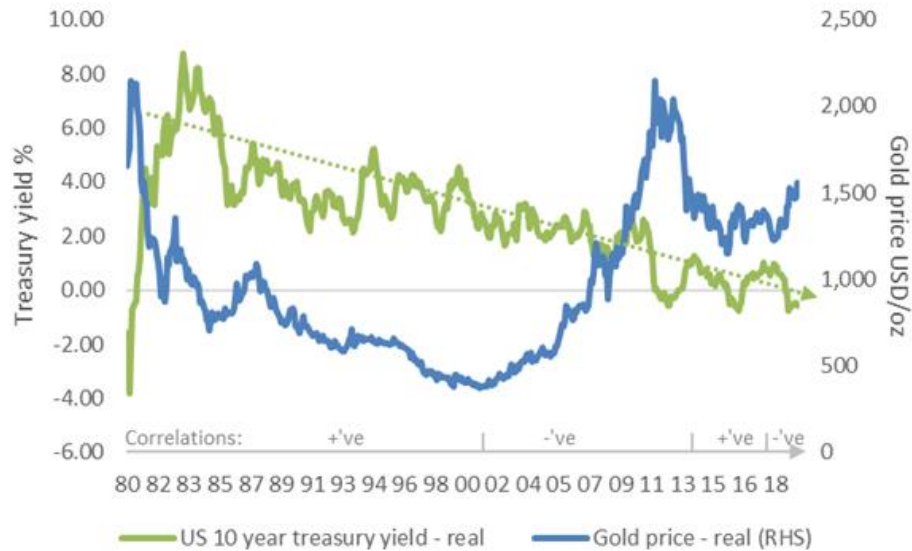
Source: World Gold Council, Calculations: Merlon Capital Partners January 2020

Comments:

- 1/3 demand is 'non-fundamental'
- This has grown from close to zero pre-GFC
- Accounts for five years of fundamental demand
- An unwind of speculative drivers is a risk

Trade war & commodities: gold

Not a stable relationship with interest rates



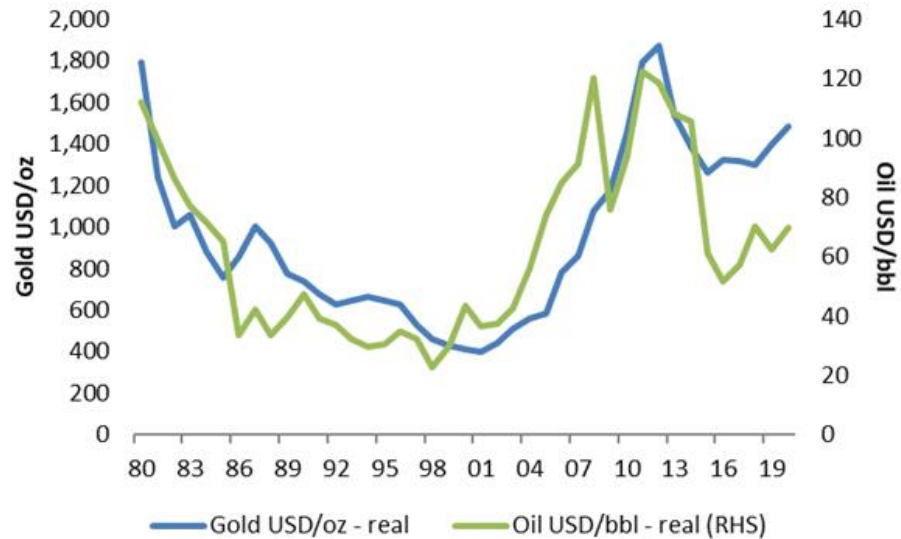
Source: Federal Reserve Bank of St. Louis. Calculations: Merlon Capital Partners January 2020

Comments:

- The relationship between yields and gold is unreliable
- Recently, higher prices have been driven by lower yields
- Yet yields and gold both declined in tandem from the early 1980s to the late 1990s

Trade war & commodities: gold

A more stable relationship with oil (inflation)



Source: Bloomberg, Calculations: Merlon Capital Partners January 2020

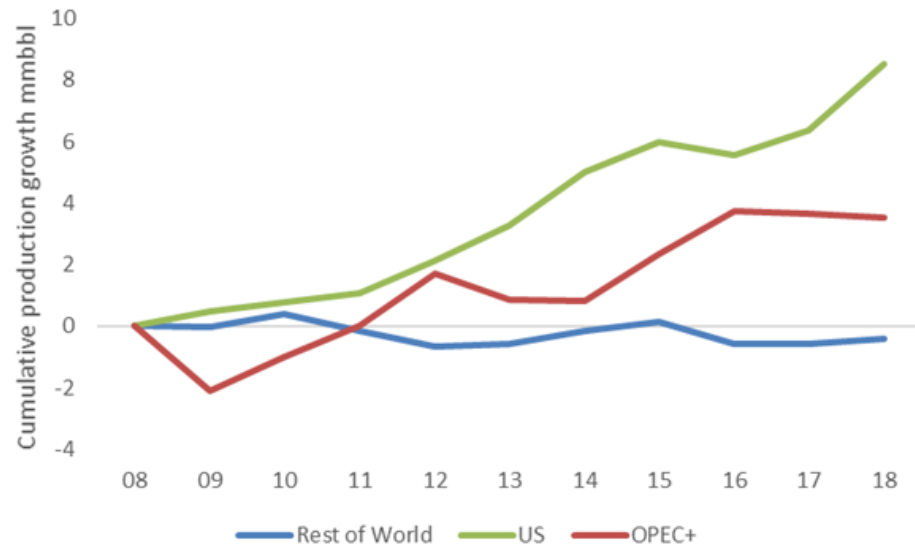
Comments:

- Relationship with oil is more consistent through time
- On this basis, gold looks expensive
- Oil is a better (cheaper) inflation hedge than gold

Trade war & commodities: oil

- **Trade war impact:** neutral, driven by reduced global trade activity
- **Longer term outlook:** trading 10% above long term averages

Production growth: US is the difference...



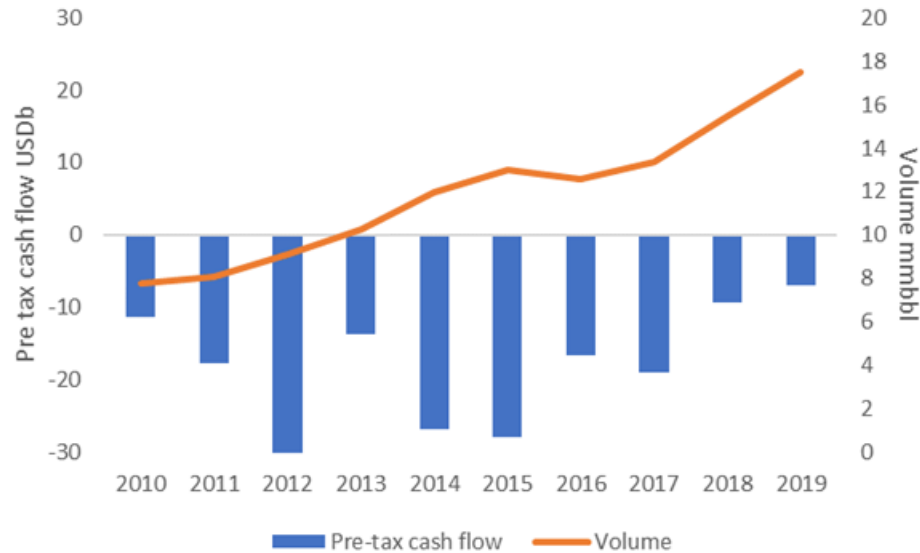
Source: BP Statistical Yearbook, Calculations: Merlon Capital Partners January 2020

Comments:

- US production growth has disrupted global oil markets
- Driven by cheap capital and technology gains

Trade war & commodities: oil

...but is not generating returns



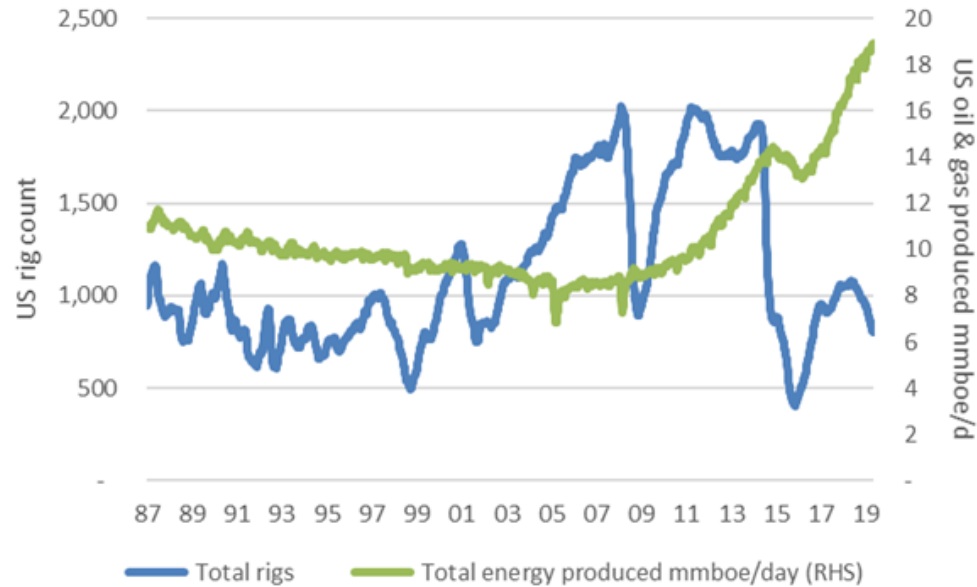
Source: Rystad Energy, Bloomberg, Calculations: Merlon Capital Partners January 2020

Comments:

- Supply growth has not seen cash returns to investors
- Despite declining global interest rates, shale players now paying up to 10% to refinance debt
- Capital discipline is emerging

Trade war & commodities: oil

Leading to reduced spending



Source: Baker Hughes / US Energy Information Administration, Calculations: Merlon Capital Partners January 2020

Comments:

- Capital discipline has seen activity declining
- Supply growth may be peaking
- The exit of loss-making volumes would support prices

Trade war & commodities: iron ore

- **Trade war impact:** +57%, driven by temporary supply disruption
- **Longer term outlook:** trading 60% above long term averages

Supply evolution



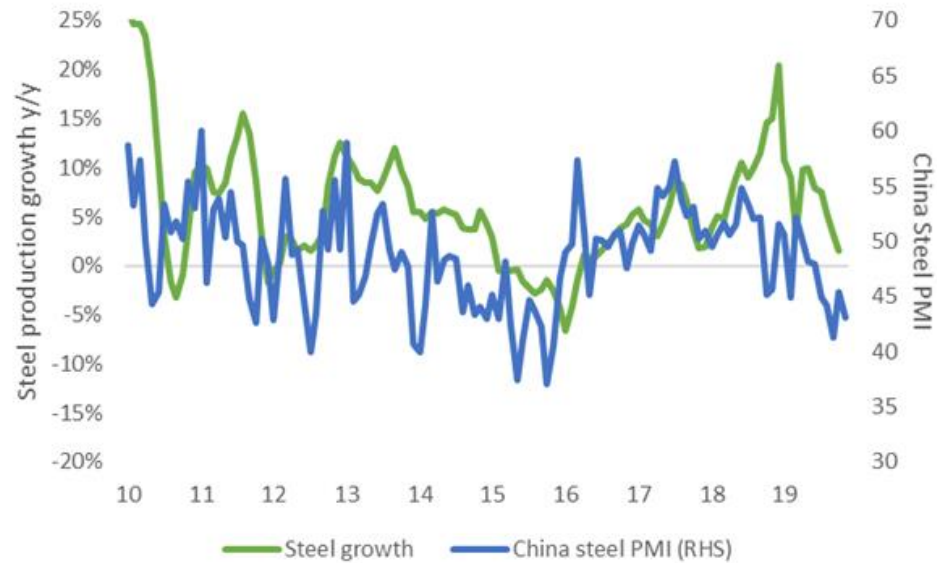
Source: WorldSteel Association, Company Guidance, Calculations: Merlon Capital Partners January 2020

Comments:

- Iron ore has been driven by temporary supply side factors
- Market remains sensitive to any supply outages
- But volumes to recover lost volumes and grow

Trade war & commodities: iron ore

Demand indicator



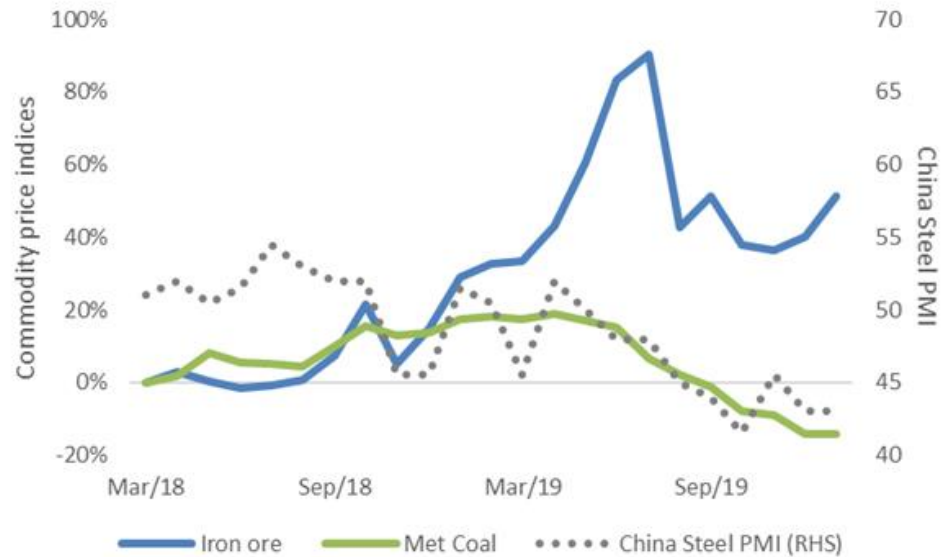
Source: Bloomberg, China National Bureau of Statistics, Calculations: Merlon Capital Partners 2020

Comments:

- Supply reforms in China saw margin recovery in CY17/18
- Supply surged in response to margins
- Steel industry conditions deteriorating due to oversupply

Trade war & commodities: iron ore

Input cost comparison



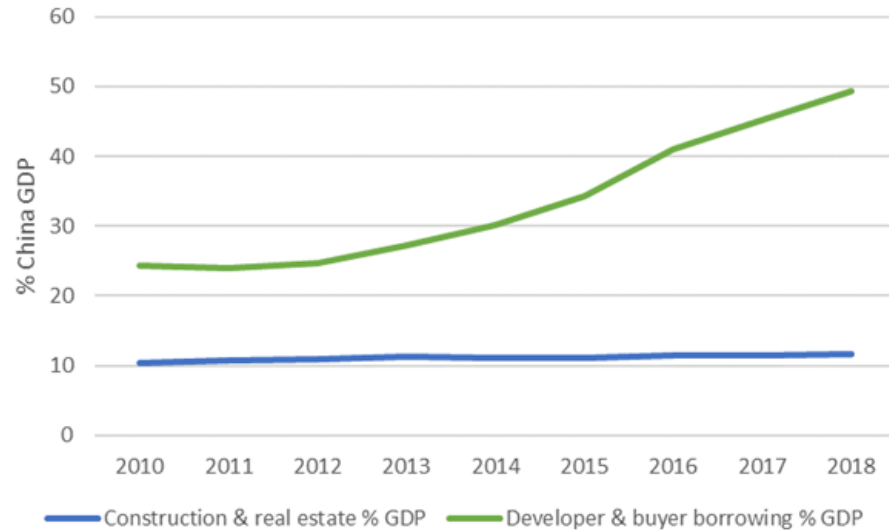
Source: Bloomberg, China Steel Logistics, Calculations: Merlon Capital Partners January 2020

Comments:

- Met coal confirming iron ore strength is supply related
- Met coal also reflective of deteriorating ex-China steel conditions

Trade war & commodities: iron ore

End user risk considerations



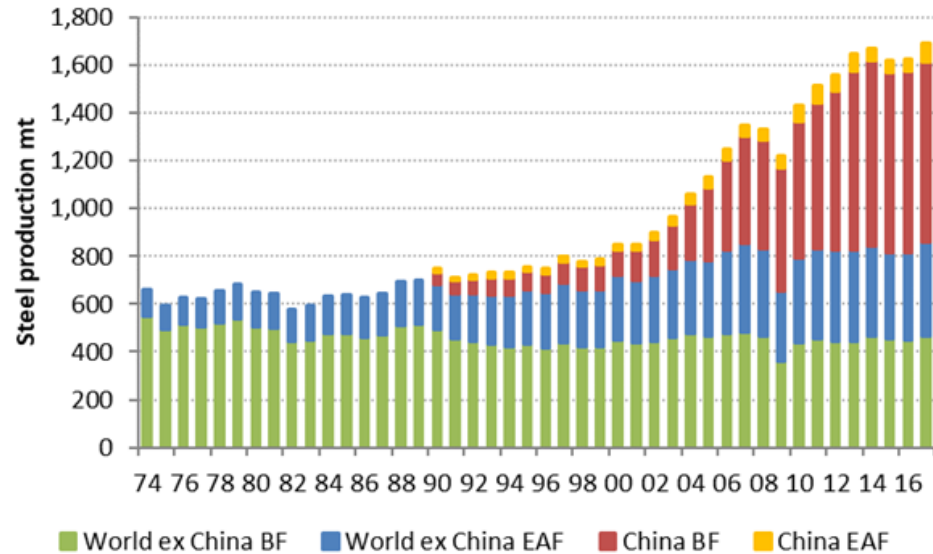
Source: Capital Economics, Calculations: Merlon Capital Partners January 2020

Comments:

- Real estate is ~10% of the Chinese economy and more than a third of steel demand
- Leverage within the real estate sector has doubled in ten years
- Despite declining global interest rates, Chinese property developers are now paying more than 10% to refinance debt

Trade war & commodities: iron ore

Longer term considerations



Source: World Steel Association, Calculations: Merlon Capital Partners January 2020

Comments:

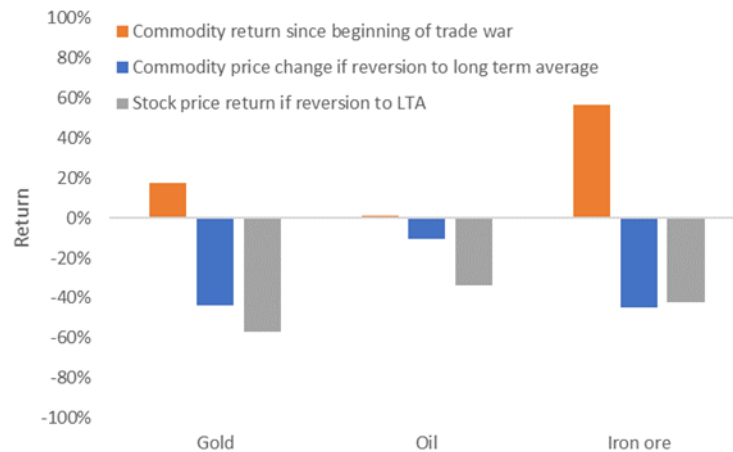
- Steel production over past 20 years to become supply as recycling rates grow
- This is reinforced by authorities now prohibiting new steel projects

Trade war & commodities: implications for investors

Returns since beginning of trade war



Downside risks are material



Comments:

- Counter to expectations, commodity-exposed stocks have rallied during the trade-war escalation
- Downside risks are evident should key trends driving commodities moderate
- These risks are exacerbated should prices return to normal levels

Outline

- ❑ Trade war & commodities

- ❑ Fund positioning and performance

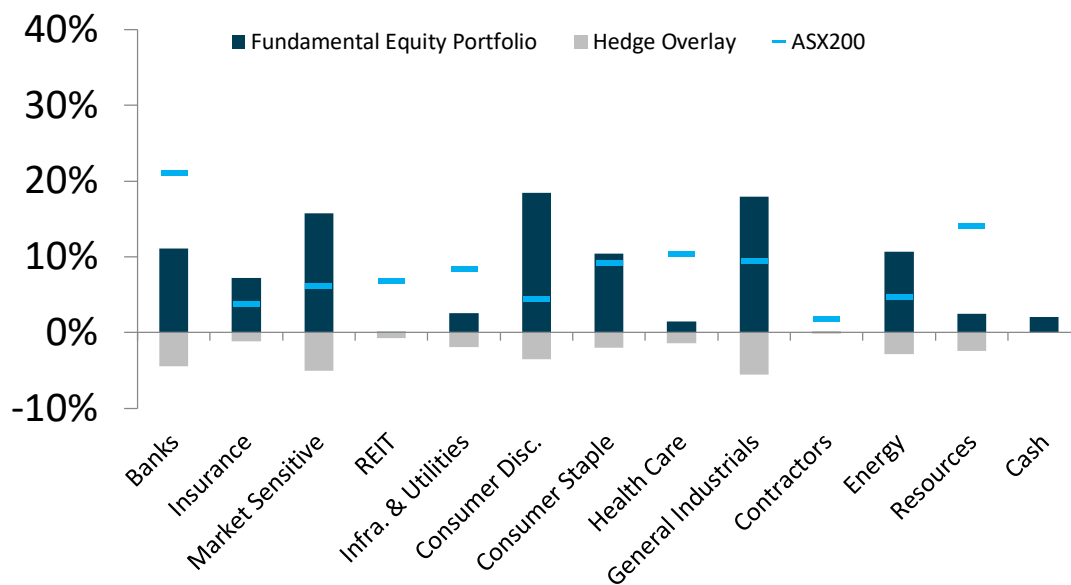
Merlon Australian Share Income Fund Performance



	FY20TD (%)	FY2019 (%)	FY2018 (%)	FY2017 (%)	FY2016 (%)	FY2015 (%)	FY2014 (%)	FY2013 (%)	FY2012 (%)	3 Years (%pa)	5 Years (% pa)	10 Years (% pa)
ASX200 Return	3.7	13.2	14.5	15.5	2.2	7.2	18.9	24.3	-5.1	11.7	10.5	9.4
Share Portfolio Excess Return	2.1	-4.8	-6.9	8.0	4.8	2.3	-2.7	11.7	1.7	-2.4	0.9	1.1
Hedge Overlay	-1.3	-0.9	-2.4	-5.6	-0.9	-1.7	-3.5	-9.3	2.6	-1.7	-2.4	-1.7
Portfolio Return (before fees)	4.6	7.5	5.1	17.9	6.1	7.8	12.8	26.7	-0.8	7.7	9.0	8.8
Portfolio Return (net of fees)	4.1	6.5	4.2	16.8	5.1	6.8	11.8	25.5	-1.7	6.6	8.0	7.8
Gross Yield	3.5	7.9	7.0	7.8	7.5	7.6	7.6	9.8	10.1	7.3	7.6	8.8
Average Daily Market Exposure	67%	69%	68%	68%	70%	70%	69%	69%	69%	69%	69%	69%

Returns for the Fund and ASX200 grossed up for accrued franking credits and the Fund return is stated as at 31 December 2019. Past performance is not a reliable indicator of future performance. Gross Distribution Yield represents the income return of the fund inclusive of franking credits (before fees).

Merlon Australian Share Income Fund - Current Fund Positioning



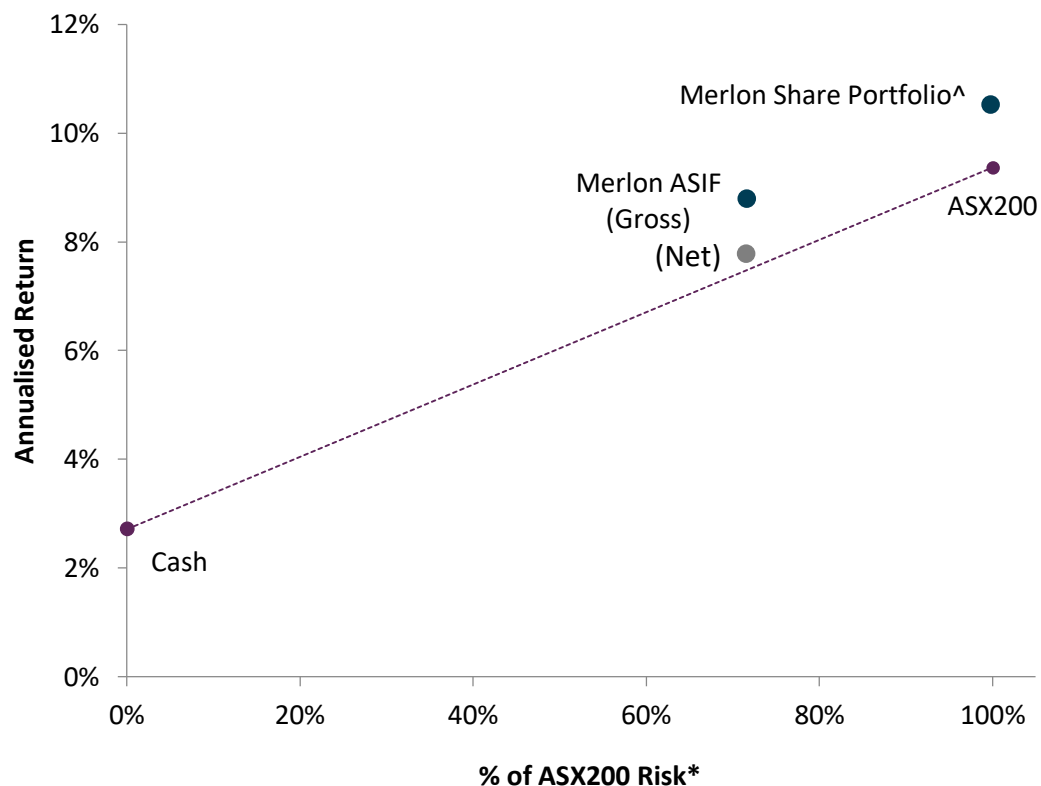
Portfolio Analytics – 31 December

	Portfolio	ASX200
Number of Equity Positions	33	200
Net Market Exposure	67%	100%
Active Share	76%	0%
Valuation Upside ¹	22%	-20%
Trailing Free Cash Yield	5.5%	4.4%
Gross Distribution Yield	6.7%	5.1%
Price / Earnings Ratio	17.1x	19.6x

Portfolio as at 31 December 2019. ¹Valuation Upside based on Merlon proprietary valuations.

Outcomes

Total Return vs Risk (10 Years)



Monthly Distribution Detail: Cents per Unit

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Total	Franking
FY2013	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.29	6.79	2.26
FY2014	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.52	6.13	1.98
FY2015	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	0.52	6.24	2.20
FY2016	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.52	6.35	1.92
FY2017	0.53	0.53	0.53	0.53	0.53	0.3	0.53	0.53	0.53	0.53	0.53	0.53	6.36	2.02
FY2018	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.52	6.35	1.84
FY2019	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.53	0.50	6.33	2.57
FY2020*	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	0.51	6.12	1.80

Returns for the Fund and ASX200 grossed up for accrued franking credits and the Fund return is stated net or gross of fees (as applicable) as at 31 December 2019.

Merlon Australian Share Income Fund franking 2.07% p.a., ASX200 franking 1.5% p.a.

*% of ASX200 Risk represents the Fund's statistical beta relative to the ASX200. Past performance is not an indication of future performance.

^Underlying portfolio returns before hedge overlay

*Forecast distribution estimates are based on Merlon's conservative best estimate of dividends over the upcoming 12 months and implied cash yields earned on hedging activity based on the portfolio composition as at the date of this document. Merlon constantly monitor these estimates through their underlying assessment of forecast free cash-flow from portfolio companies and how this translates to dividends to equity holders based on historical and forward looking analysis. Information is predictive in nature, may be affected by inaccurate assumptions or known or unknown risks and uncertainties, and may differ materially from results achieved. Results are not guaranteed.

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This focus on capital preservation and growth delivers

Sustainable Income

Paid monthly and majority franked

A bit more about your presenters



Neil Margolis
Lead Portfolio Manager

Neil Margolis founded Merlon Capital Partners in May 2010. Prior to Merlon, Neil was Portfolio Manager of Challenger Limited's Australian Share Income Fund, having established the strategy in 2005. Neil joined Challenger in 2004 as a Senior Industrials Analyst from Alliance Capital Management where he held the position of Senior Equities Analyst. Neil was with Alliance for three years, and prior to that worked for JP Morgan Investment Bank.

Neil holds a B.BusSc (Hons), CA and CFA.



Ben Goodwin
Analyst/Portfolio Manager

Ben joined Merlon Capital Partners as a Principal upon its inception in May 2010. Prior to joining Merlon, Ben was Head of Research and Information at Challenger Limited, managing the risk and quantitative research processes across all portfolios, as well as conducting tailored fundamental research, macro and commodity based research. Ben has held similar roles at First State Investments (UK), Colonial First State (Australia), and BT Funds Management.

Ben holds a B.Ec (Hons).

Thank you