

# Merlon Australian Share Income Fund

Delivering Sustainable Income From Australian Shares

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# How Merlon Approach is Different

## **Sustainable Income**

*Paid monthly and majority franked*

*by focusing on capital preservation and growth*

### **Fundamental Research**

*Focused on  
sustainable cash flow*

### **Portfolio Diversification**

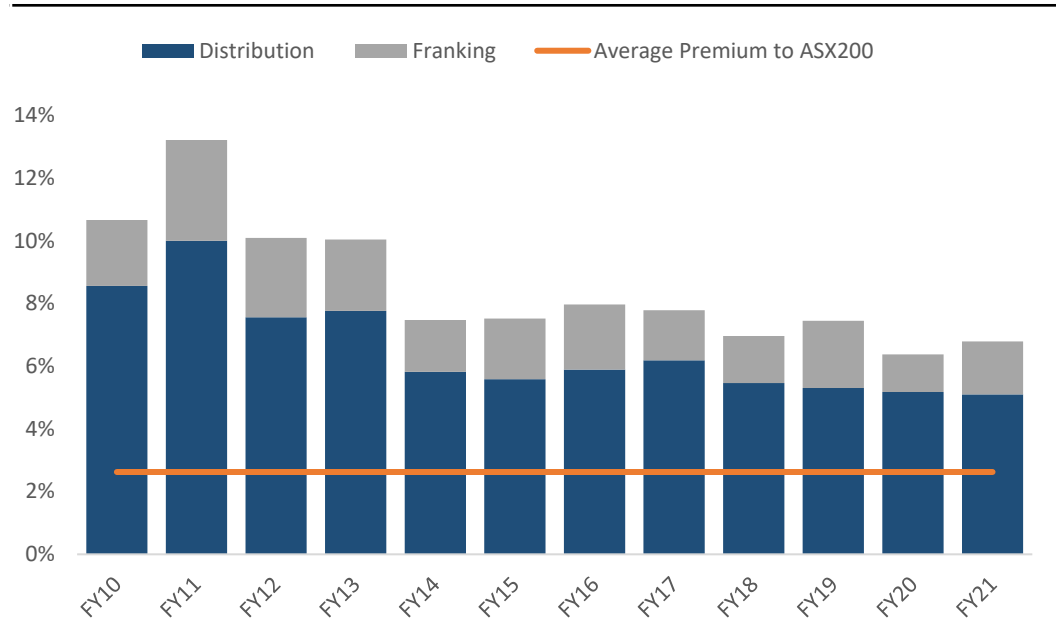
*No reference to  
ASX200 weights*

### **Downside Protection**

*Through research &  
risk reduction overlay*

# Above market income and franking, paid monthly

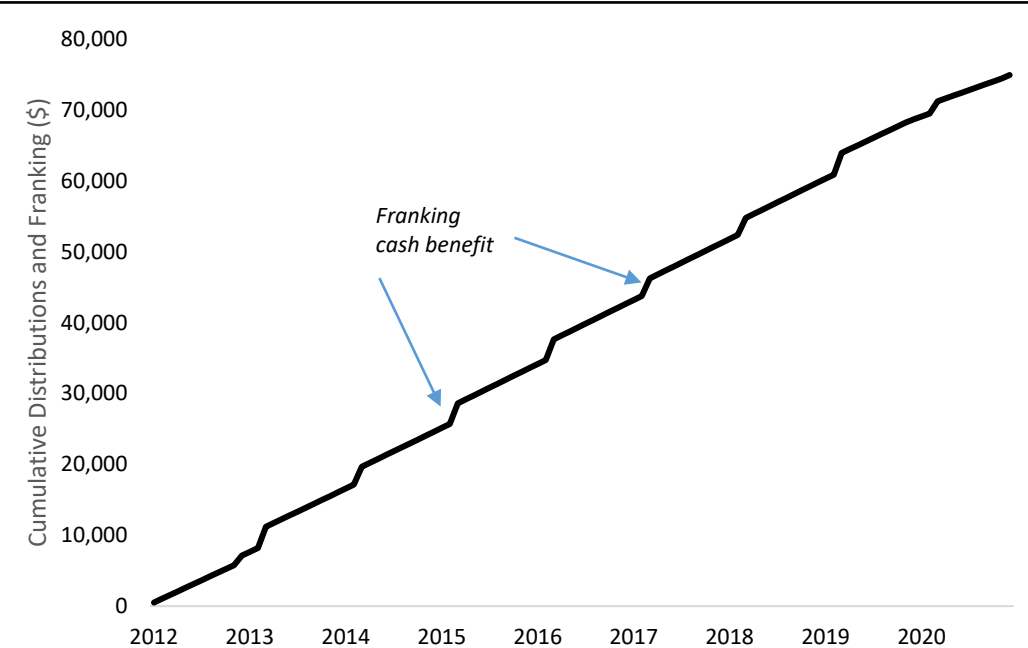
### Historic distribution yield



Source: Merlon, Fidante

**Average yield premium of 2.6%**

### Cumulative income on \$100,000 invested in July 2012

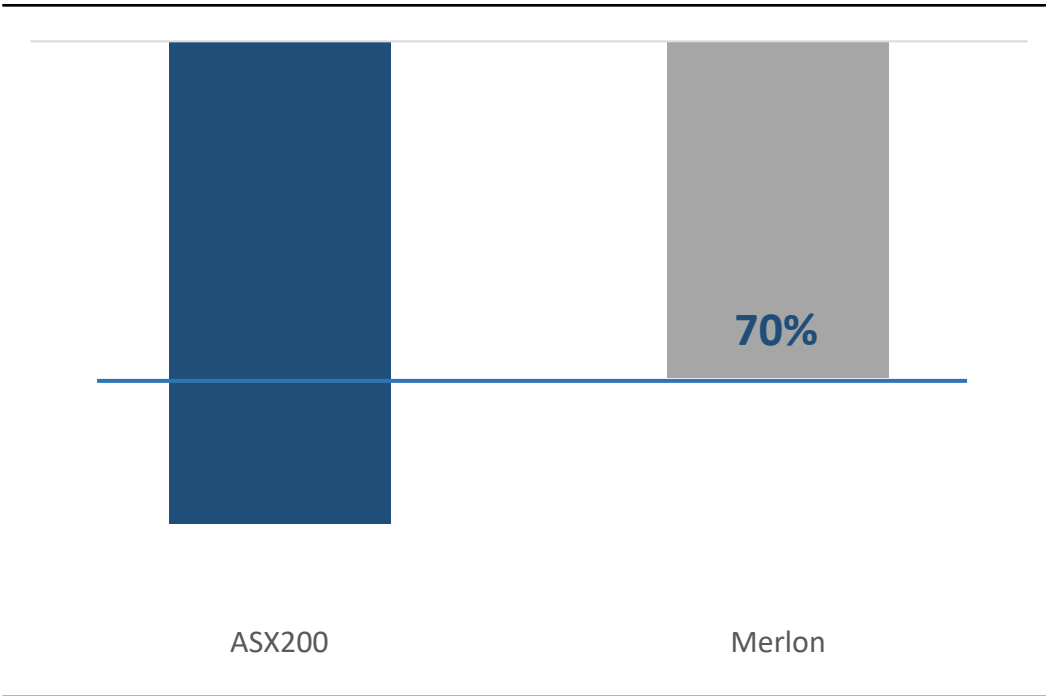


Source: Merlon, Fidante at July-21. Assumes no reinvestment. Franking is accrued monthly and assumed to be paid to investor in Sept after the financial year end. Cash distributions beyond date of this presentations are forecast guidance.

**5.8% gross yield at present**

# Downside Protection Overlay acts as a shock absorber in down markets

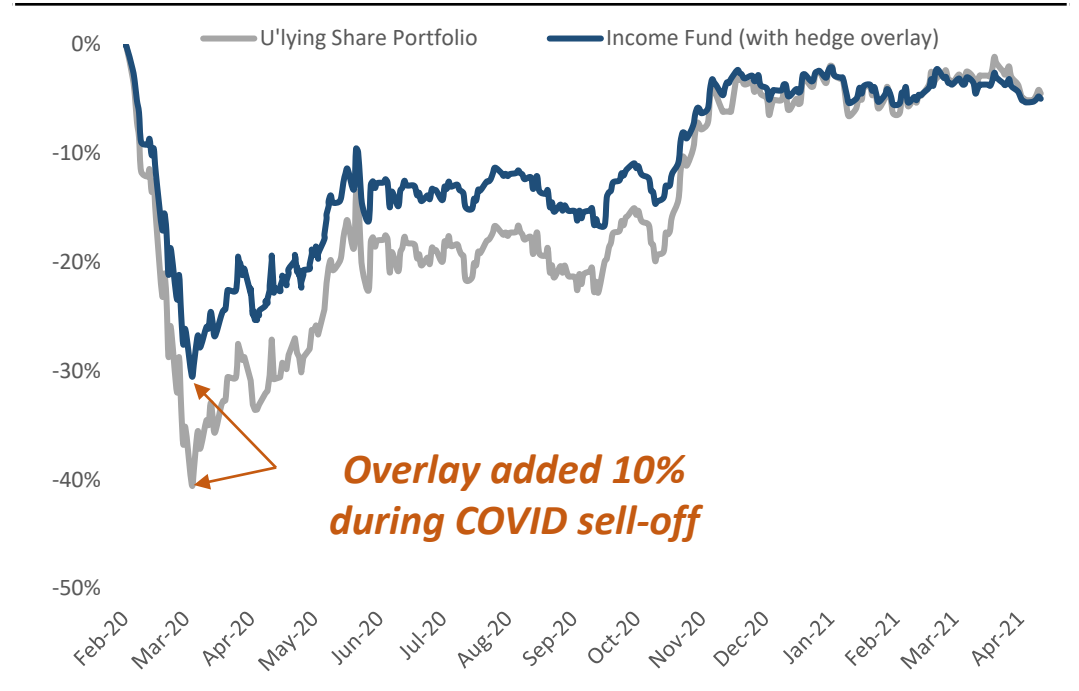
## Performance in down markets



Average relative return compared to ASX200 where ASX200 monthly return is negative since June 2010.

**On average 30% downside protection**

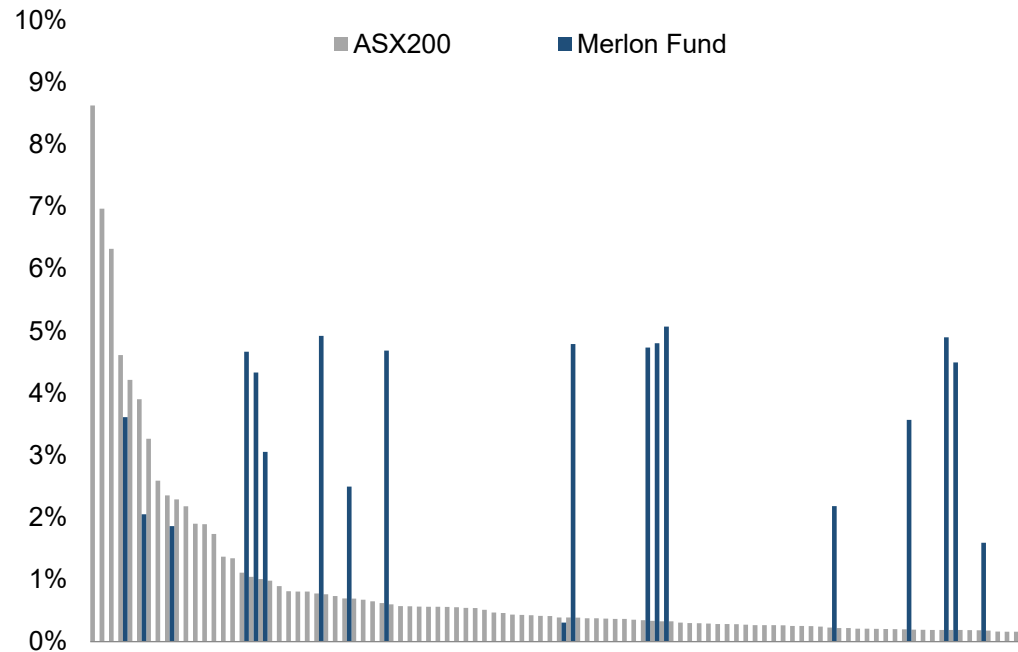
## Performance since 20 February 2020



Merlon Australian Share Income Fund compared to the underlying share portfolio over the period 20 February 2020 to 30 April 2021

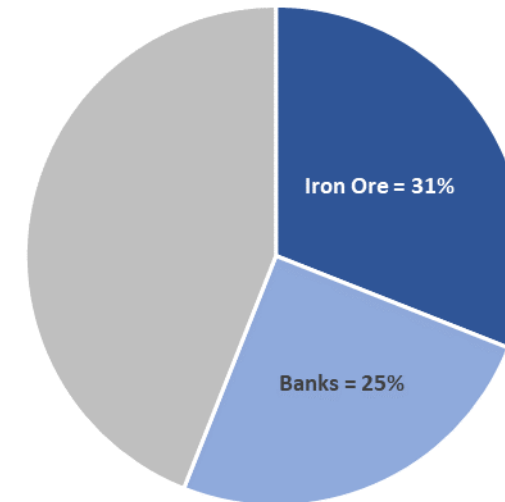
# Index unaware portfolio provides diversification

## The ASX200 is skewed to ultra-large companies



ASX200 index weights relative to Merlon portfolio. As at 30 June 2021

## ASX200 dividends are heavily skewed to macro sensitive companies



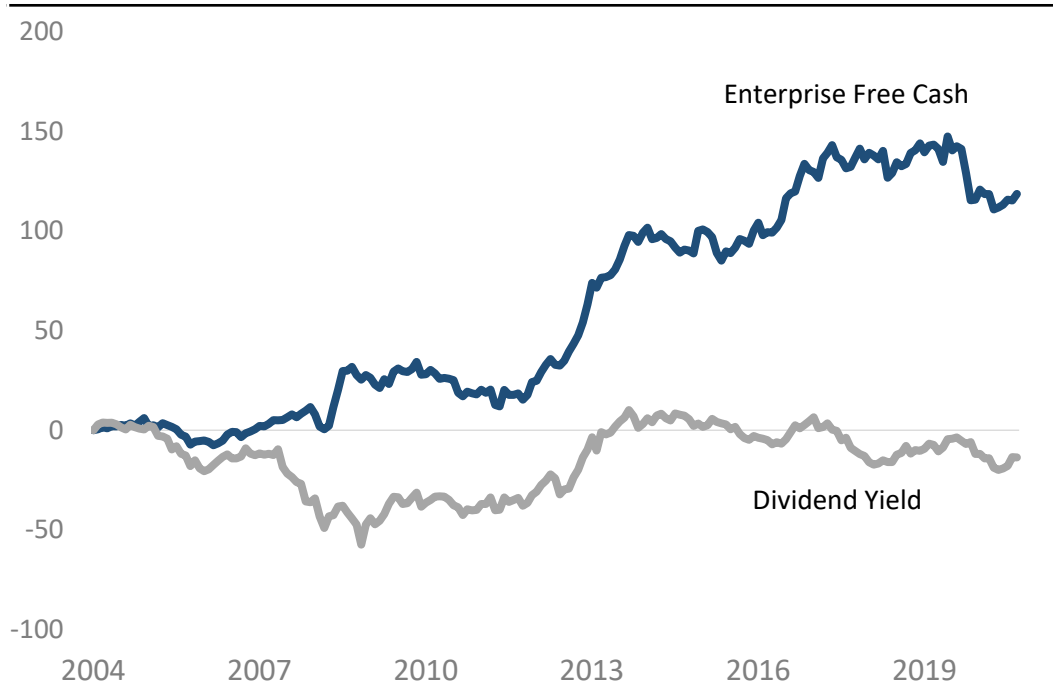
Source: Percentage contribution to ASX200 index dividends based on Bloomberg, July 2021

***More diverse sources of income and growth***

# A focus on free cash flow provides long term downside protection



## Free cash flow a better measure than dividends



Portfolios are formed using enterprise-free-cash-flow-to-enterprise-value (EF/EV) and dividend yield. Portfolios are formed at the end of each month by sorting on one of the ratios and then computing equally-weighted returns for the following month. The “value” portfolios contain firms in the top one third of a ratio and the “glamour” portfolios contain firms in the bottom third. The analysis is based on S&P/ASX200 constituents and the raw data is from Bloomberg. Risk is defined as annualised standard deviation of monthly returns.

**Free cash flow ultimately funds dividends**

### What is EFCF?

- ❑ Cash flow to pay lenders and shareholders
- ❑ Accounts for capital to sustain and grow business

### Why it outperforms?

- ❑ Cash flow looks through accounting manipulation
- ❑ Penalises companies if debt levels too high

### Relevance to Income Investing

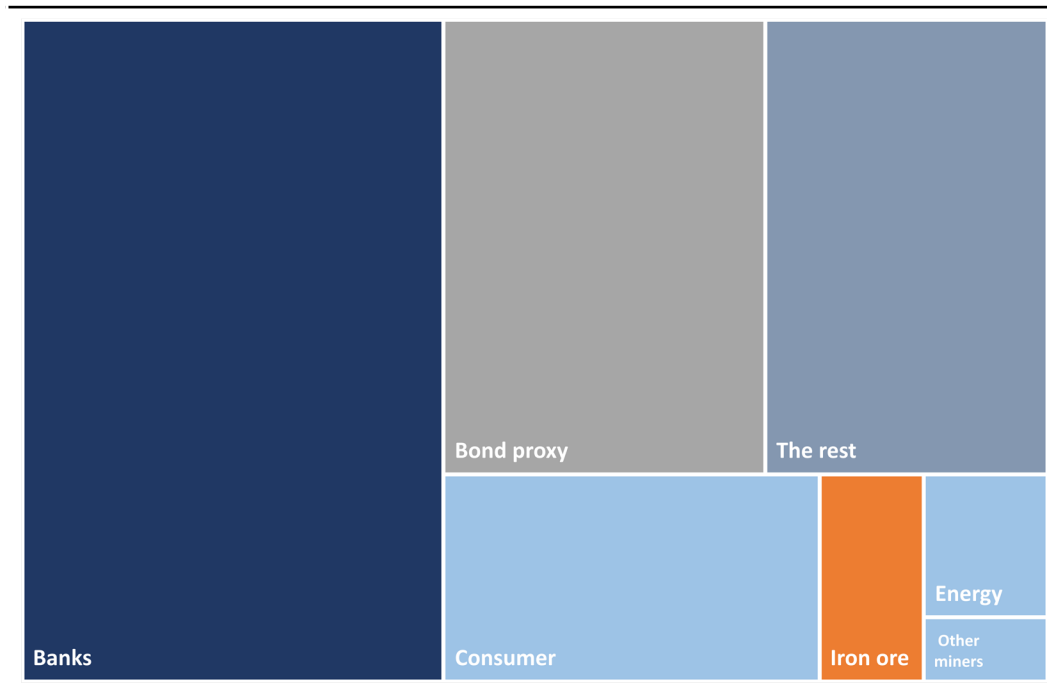
- ❑ Dividends sustainable if funded from cash flow
- ❑ Dividends sustainable if debt levels manageable

# Dividend Outlook



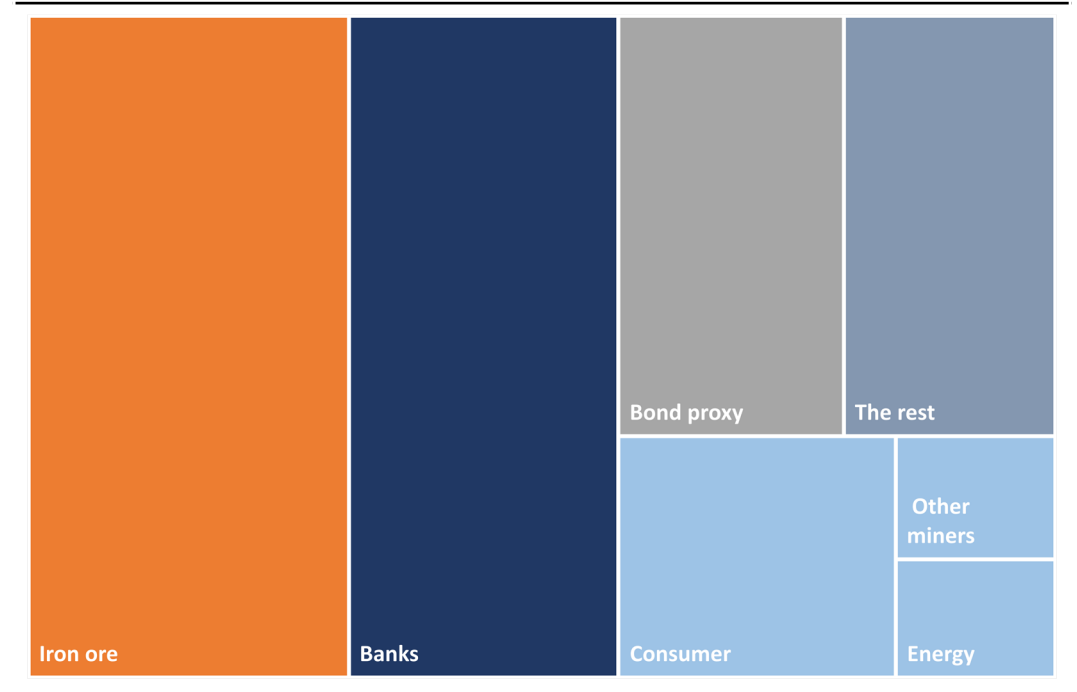
# Composition of ASX200 yield should raise alarm bells

### Composition of ASX200 dividend yield 5 years ago



Source: Bloomberg, 30 June 2016.

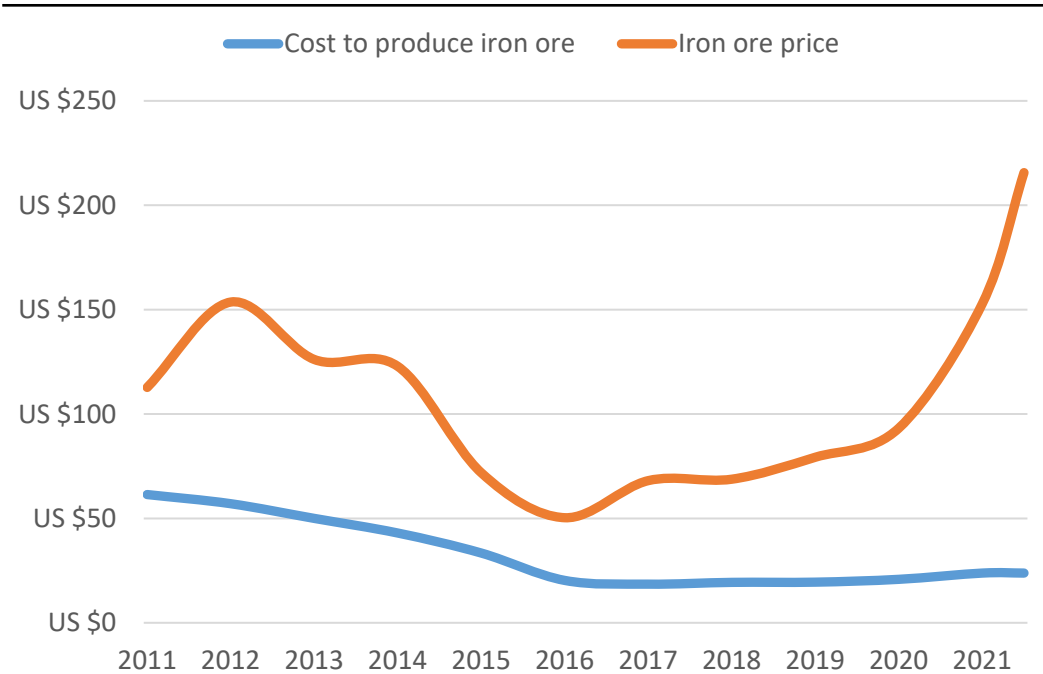
### Composition of ASX200 dividend yield today



Source: Bloomberg, 30 June 2021

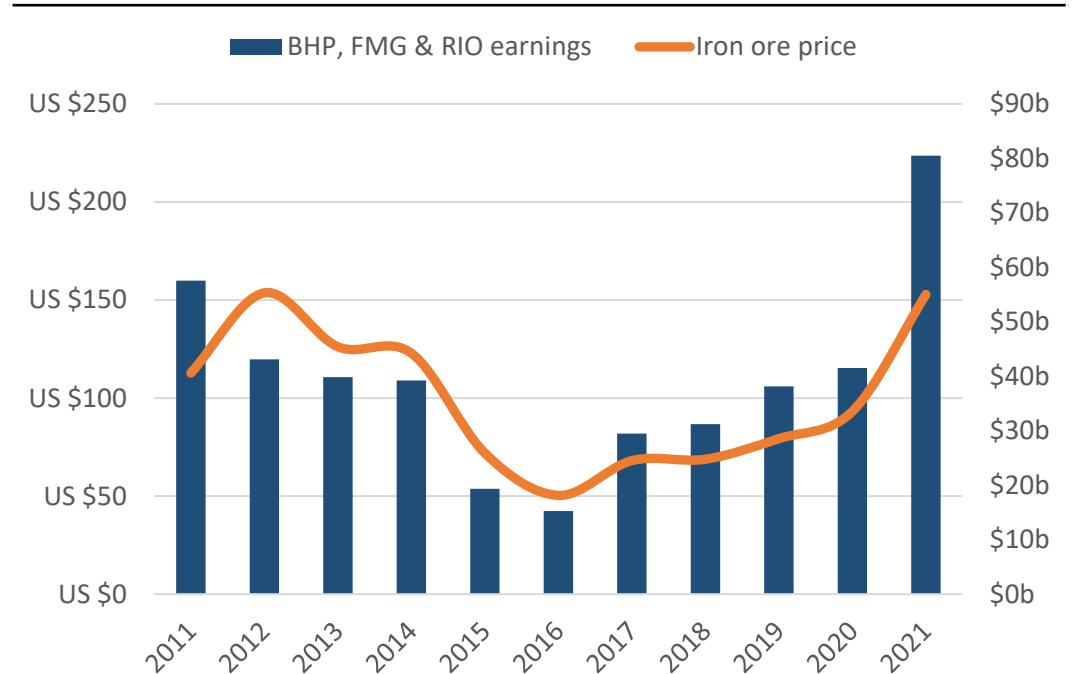
# Iron ore earnings and dividends appear unsustainably high

**Iron ore price disconnected from cost of production**



Source: Bloomberg, Company accounts, Merlon. Production costs of Fortescue Metals Group.

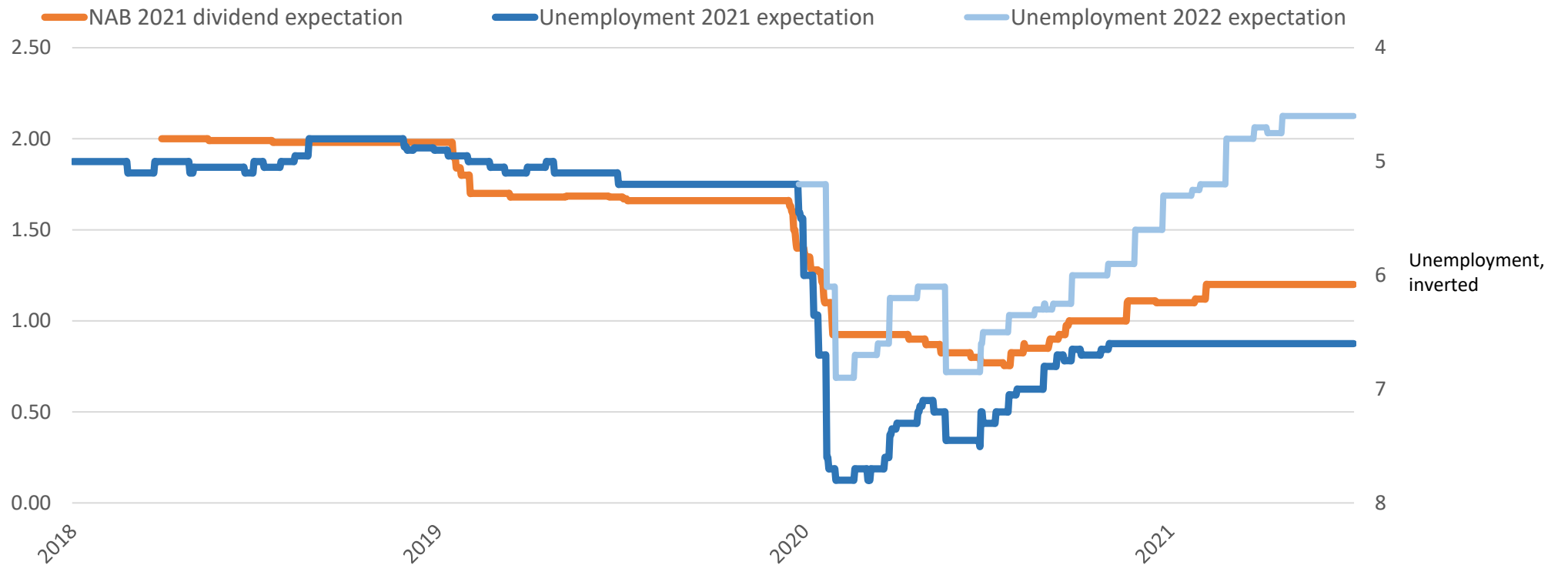
**Earnings and dividends connected to iron ore price**



Source: Bloomberg, Merlon. Earnings Before Interest & Tax. 2021 and 2022 forecasts.

# Bank dividends inextricably linked to the economy

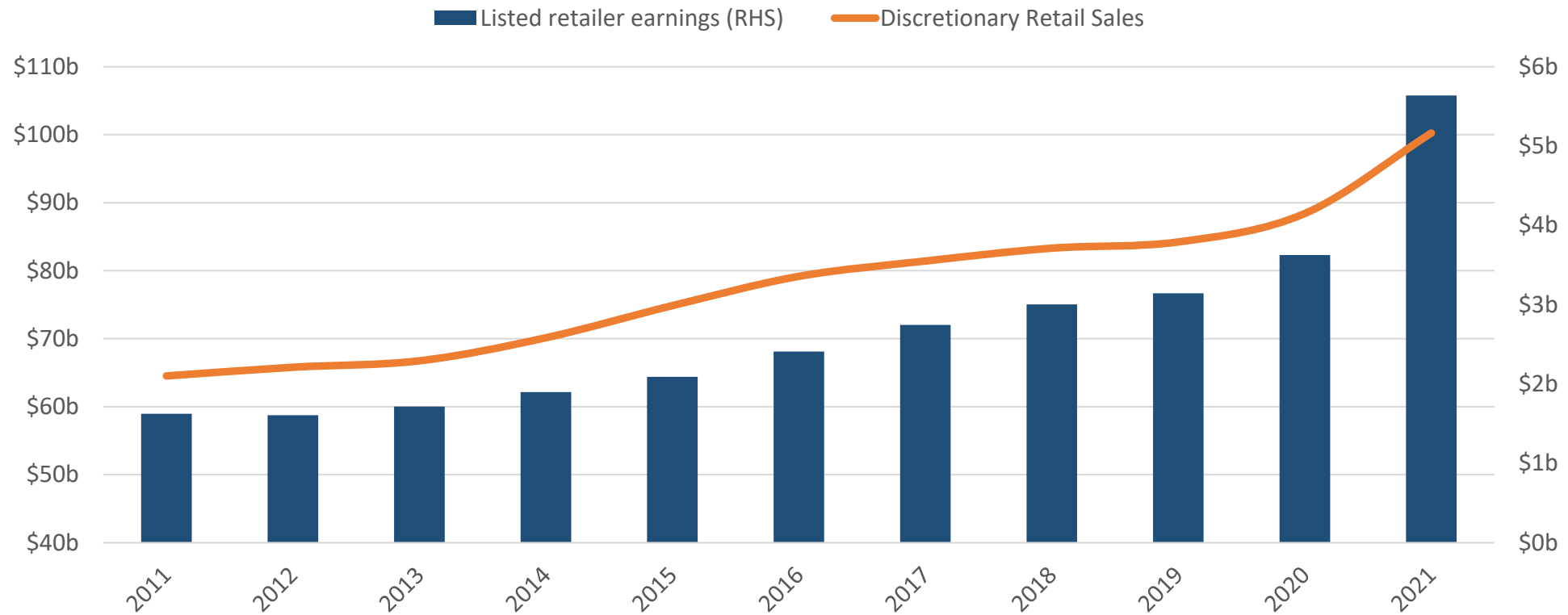
## Unemployment and bad debt expectations



Source: Bloomberg, 30 July 2021

# Retail booming unless you are a tour operator or restaurateur

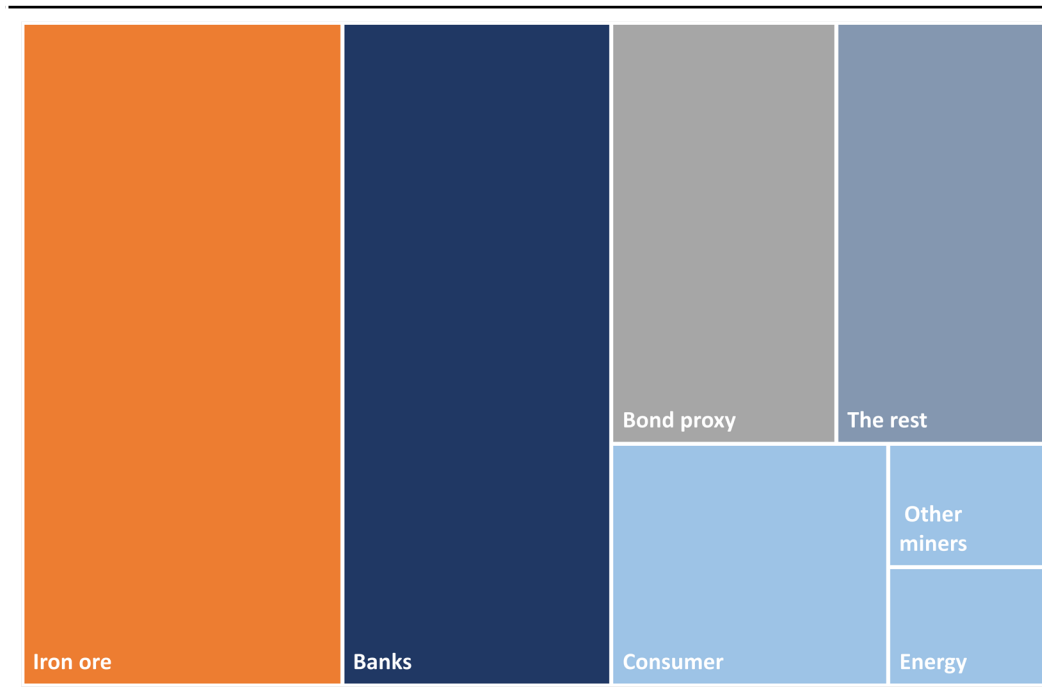
## Retail sales ex hospitality and listed retailer earnings



Source: ABS, Company accounts, Merlon

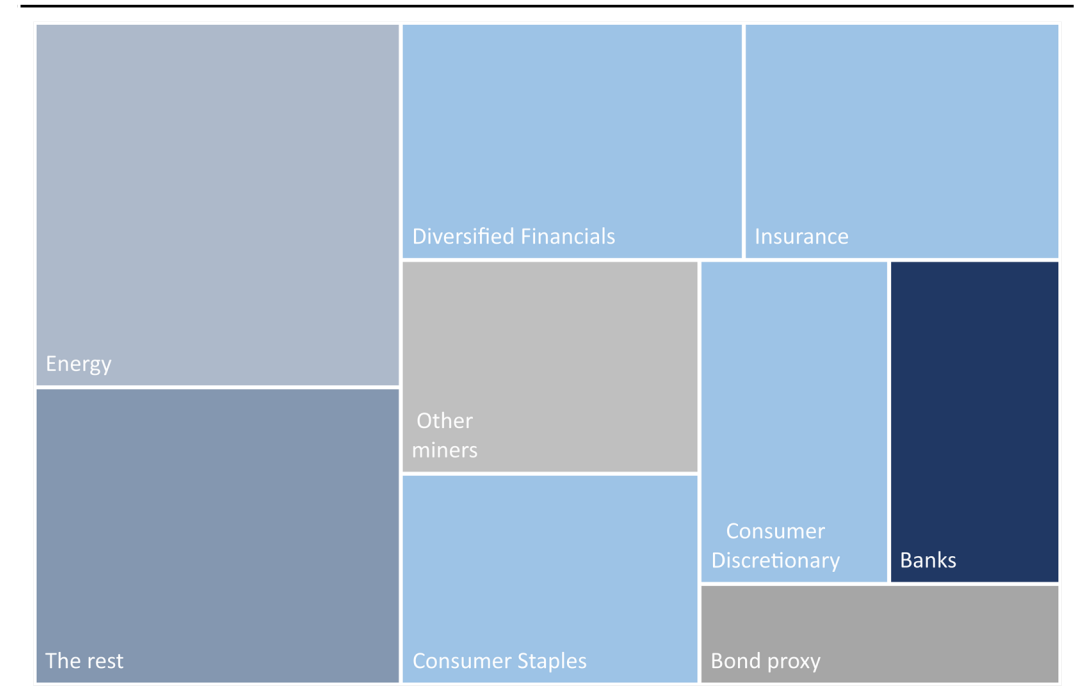
# Merlon portfolio offers more diverse sources of franked income

### Composition of ASX200 dividend yield today



Source: Bloomberg, Merlon, 30 June 2021

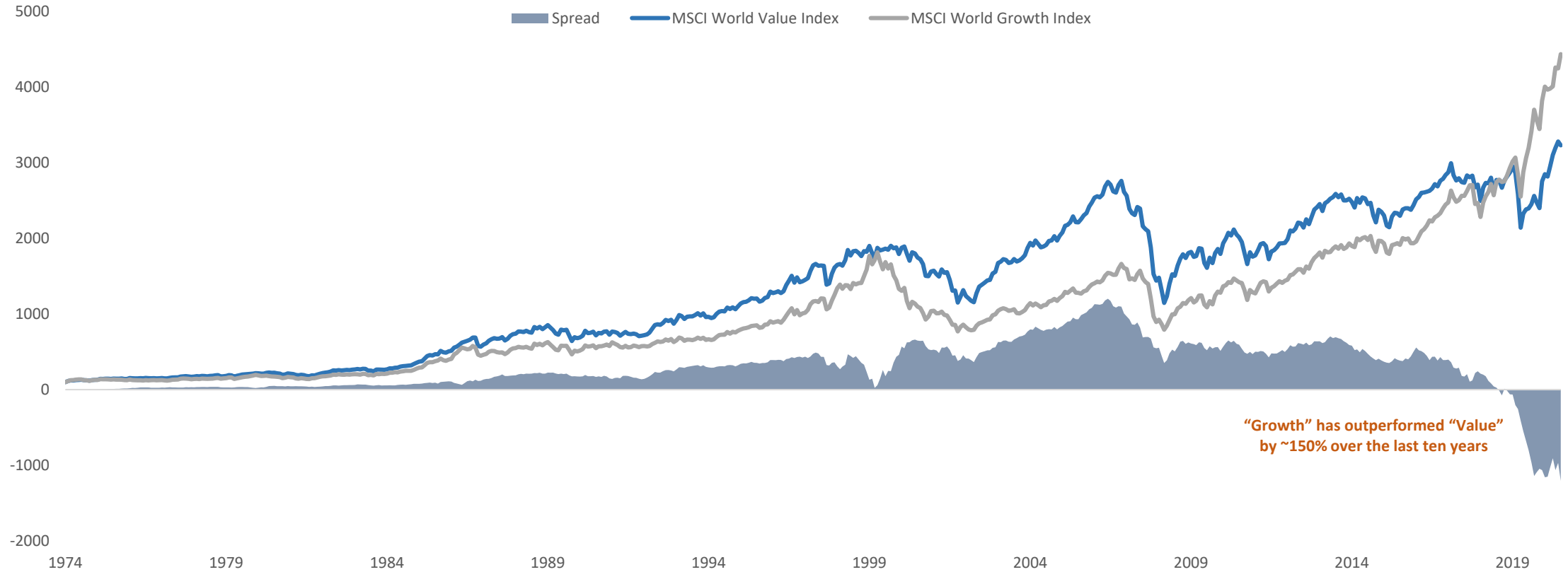
### Composition of Merlon's dividend yield



Source: Bloomberg, Merlon, 30 June 2021

# Portfolio Outlook & Performance

# “Growth” vs “Value” – a longer term perspective



“Growth” has outperformed “Value”  
by ~150% over the last ten years

*Value investing due for a comeback*

# Fund Performance



	Quarter (%)	Year (%)	3 Years (% pa)	5 Years (% pa)	10 Years (% pa)
Fund Return (before fees)	2.9	17.7	6.2	8.2	9.2
70% ASX200 / 30% Bank Bills	5.9	19.7	8.3	9.3	8.4
ASX200	8.5	28.8	10.9	12.5	10.7
<b>Fund Return (net of fees)</b>	<b>2.7</b>	<b>16.6</b>	<b>5.2</b>	<b>7.2</b>	<b>8.2</b>
<b>Gross Income</b>	<b>1.3</b>	<b>6.8</b>	<b>7.1</b>	<b>7.2</b>	<b>7.9</b>

## Performance in Rising Markets



Source: Merlon, Fidante, Average returns (before fees & inc. franking) where the ASX200 return is positive for the fiscal year. FYTD, 2019, 2018, 2017, 2016, 2015, 2014, 2013, 2011, 2010, 2007.

## Performance in Falling Markets



Source: Merlon, Fidante, Average returns (before fees & inc. franking) where the ASX200 return is negative for the fiscal year. FY2020, 2012, 2009, 2008.

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 30 June 2021. Past performance is not a reliable indicator of future performance. Gross Income represents the income return of the fund inclusive of franking credits (after fees).



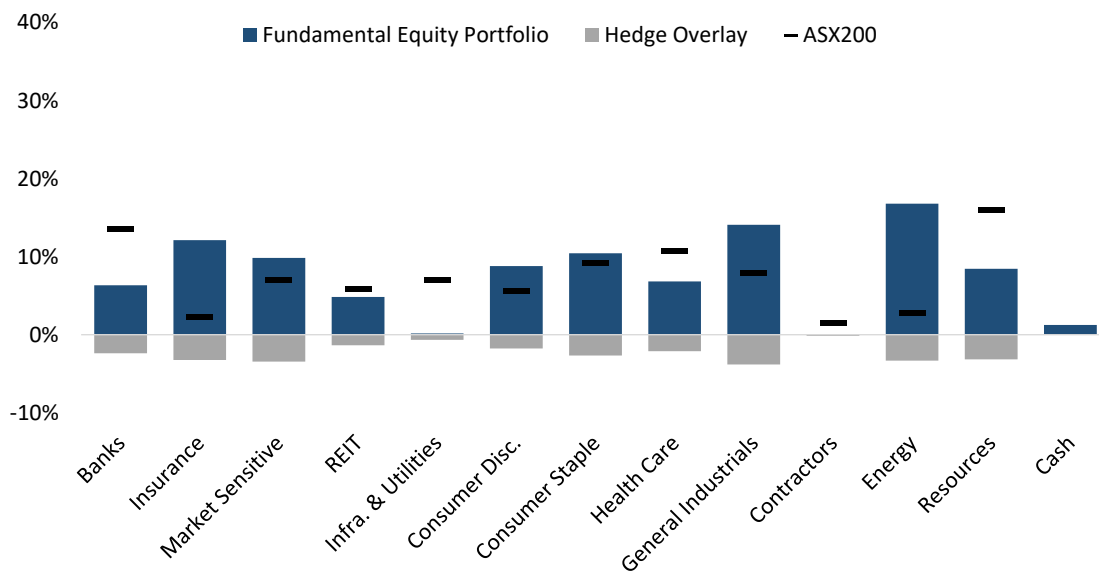
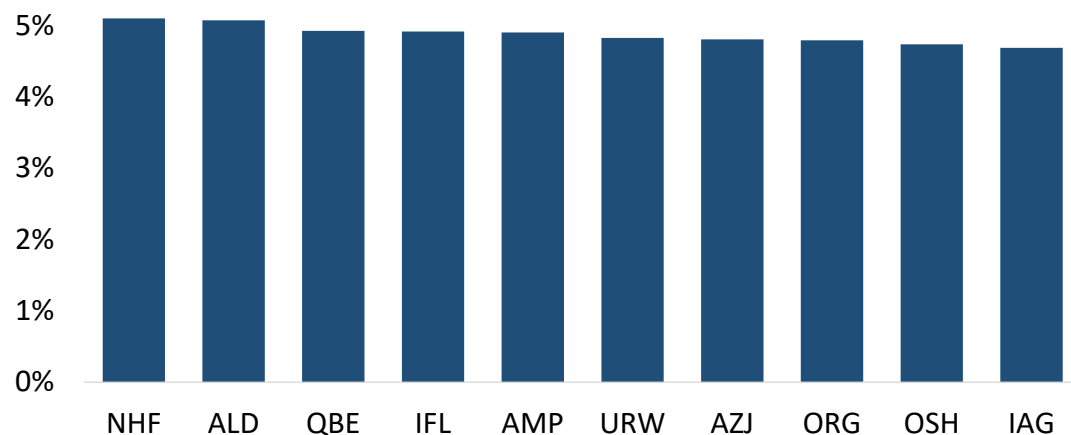
# Fund Performance by Financial Year



	FY2021 (%)	FY2020 (%)	FY2019 (%)	FY2018 (%)	FY2017 (%)	FY2016 (%)	FY2015 (%)	FY2014 (%)	FY2013 (%)	FY2012 (%)	10 Years (% pa)
ASX200 Return	28.8	-6.5	13.2	14.5	15.5	2.2	7.2	18.9	24.3	-5.1	10.7
Share Portfolio Excess Return	-2.0	-2.8	-4.8	-6.9	8.0	4.8	2.3	-2.7	11.7	1.7	0.7
Downside Protection Overlay	-9.1	3.9	-0.9	-2.4	-5.6	-0.9	-1.7	-3.5	-9.3	2.6	-2.2
Portfolio Return (before fees)	17.7	-5.4	7.5	5.1	17.9	6.1	7.8	12.8	26.7	-0.8	9.2
Portfolio Return (net of fees)	16.6	-6.3	6.5	4.2	16.8	5.1	6.8	11.8	25.5	-1.7	8.2
Gross Yield	6.8	6.4	7.9	7.0	7.8	7.5	7.6	7.6	9.8	10.1	7.9
Average Daily Market Exposure	66%	67%	69%	68%	68%	70%	70%	69%	69%	69%	68%

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 30 June 2021.  
 Past performance is not a reliable indicator of future performance. Gross Distribution Yield represents the income return of the fund inclusive of franking credits (after fees).

# Current Fund Positioning



## Portfolio Analytics (30 June)

### Above Market Income

Mid-cycle Free Cash Flow Yield

Portfolio	ASX200
7.0%	3.1%
5.8%	5.1%
47%	-22%
15.5x	20.2x
32	200
83%	0%
69%	100%

Gross Distribution Yield

### Fundamental Research

Valuation Upside<sup>1</sup>

Price / Earnings Ratio

### Portfolio Diversification

Number of Equity Positions

Active Share

### Downside Protection

Net Market Exposure

Portfolio as at 30 June 2021. <sup>1</sup>Valuation Upside based on Merlon proprietary valuations.

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### **Downside Protection**

*Through research &  
risk reduction overlay*

# A bit more about your presenter



## 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.

*Thank you*