

# Merlon Concentrated Australian Share Strategy

June 2022



## 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

<b>Portfolio managers</b>	Neil Margolis and Hamish Carlisle
<b>Strategy inception date</b>	13 <sup>th</sup> October 2017
<b>Merlon FUM</b>	\$970m
<b>Strategy FUM</b>	\$416m

## Quarterly value added relative to benchmark

Top 5	Value Added (%)
Ampol Ltd	0.7
QBE Insurance Group Limited	0.7
New Hope Corporation Ltd	0.5
Viva Energy Group Ltd	0.5
Aurizon Holdings Ltd	0.5

Bottom 5	Value Added (%)
Transurban Group Stapled	-0.4
Unibail Group Stapled	-0.5
Insignia Financial Ltd	-0.6
Alumina Limited	-0.6
CSL Limited	-0.7

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

## Strategy Performance gross of all fees and expenses

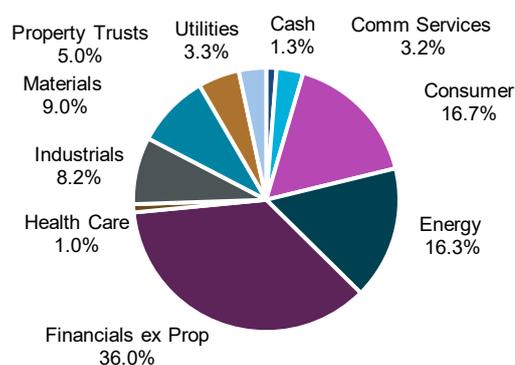
% <sup>1</sup>	Fund	Benchmark <sup>2</sup>	Excess
<b>10 years (p.a.)</b>	12.6	10.7	1.9
<b>7 years (p.a.)</b>	9.5	8.3	1.2
<b>5 Years (p.a.)</b>	7.4	8.2	-0.8
<b>3 Years (p.a.)</b>	7.1	4.5	2.5
<b>1 Year</b>	6.9	-5.0	11.9
<b>FYTD</b>	6.9	-5.0	11.9
<b>Quarter</b>	-7.1	-11.7	4.6
<b>1 Month</b>	-7.9	-8.8	0.8

<sup>1</sup> Performance figures are calculated before 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.

<sup>2</sup> The Fund benchmark is the S&P/ASX 200 Accumulation Index (inclusive of franking credits). Strategy Inception date is 31 May 2010.

Source: Fidante Partners Limited, 30 June 2022.

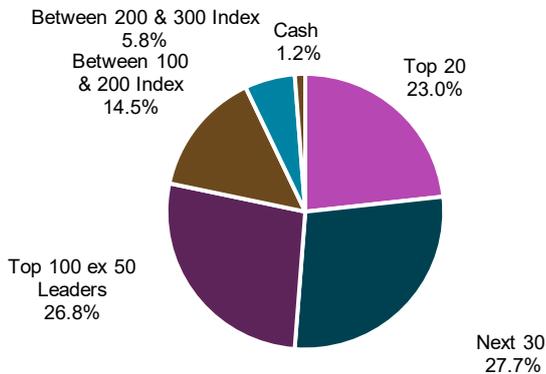
## Sector Exposure



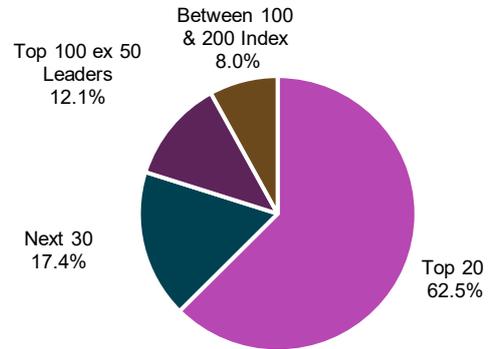
## Top 10 Holdings (Alphabetical)

AMP Limited	Qantas Airways Limited
Aurizon Holdings Ltd	QBE Insurance Group Limited
Coles Group Ltd	Suncorp Group
Insurance Australia Group	Westpac Banking Corporation
Medibank Pvt Ltd	Woodside Petroleum Limited

## Market Cap Bands - Fund



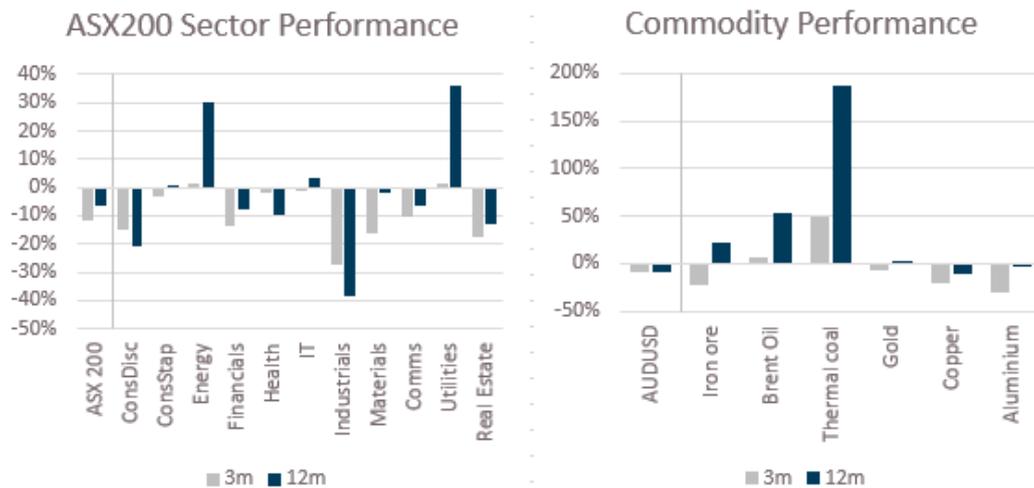
## Market Cap Bands – ASX 200



## Market Review and Outlook

The Australian market shed 11.7% during the quarter, ending the financial year down over 5%. All sectors were negative, with the exception the Energy and Utilities sectors, primarily a function of continued demand normalisation meeting the effect of several years of underinvestment. Russia’s early 2022 invasion of Ukraine heightened energy market tensions.

**Figure 1: Overview of key markets**



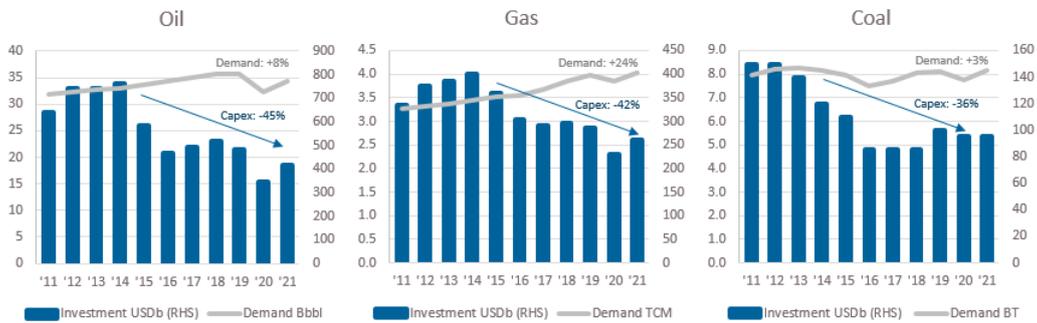
Data source: Bloomberg, Merlon Capital.

As inflation continued to rise and prove less transitory than expected – driven by supply constraints and spiking energy prices - central banks moved quickly to commence an aggressive tightening phase. This process seems likely to be more rapid than seen in recent cycles to combat inflation, while central banks are also cognizant that prior policy normalisation efforts fell short of targeted levels before cycles turned.

Markets are now firmly focused on the risks of recession, as COVID stimulus fades, while higher than expected inflation strangles purchasing power. We can see activity levels in the US and Europe falling relatively quickly, and into contractionary levels in the case of leading indicators such as manufacturing new orders.

**Energy markets:** As per previous reports, we saw energy prices continue to rise, a function of greater demand pulling on underinvested supply chains.

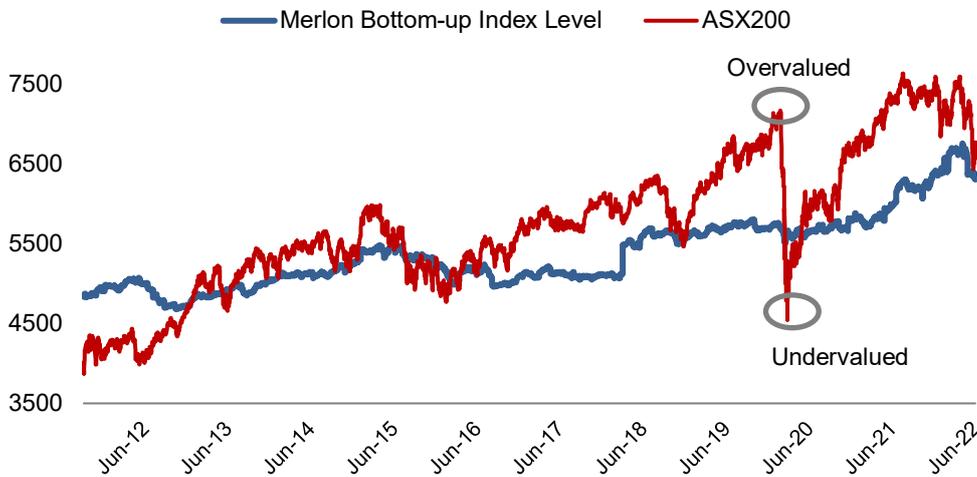
**Figure 1a: System investment vs demand – global energy markets**



Data source: International Energy Agency Calculations: Merlon Capital.

Russia’s military activities in Ukraine continued beyond 100 days, emphasising the need for Europe to pivot towards new sources of traditional fuels as well as renewable energy systems. The pressure to continue to provide energy for their populations as well as continue to development renewable power, has seen the European Parliament support EU labelling gas as ‘green’ investment. While previously considered unlikely, Russia’s invasion has seen priorities shift. Germany now seeks to reverse more than five decades of Russian energy dependency, reducing Russia’s share of imports of gas from 55% to 10% by mid-2024. Again, this is increasing demand further on underinvested supply chains.

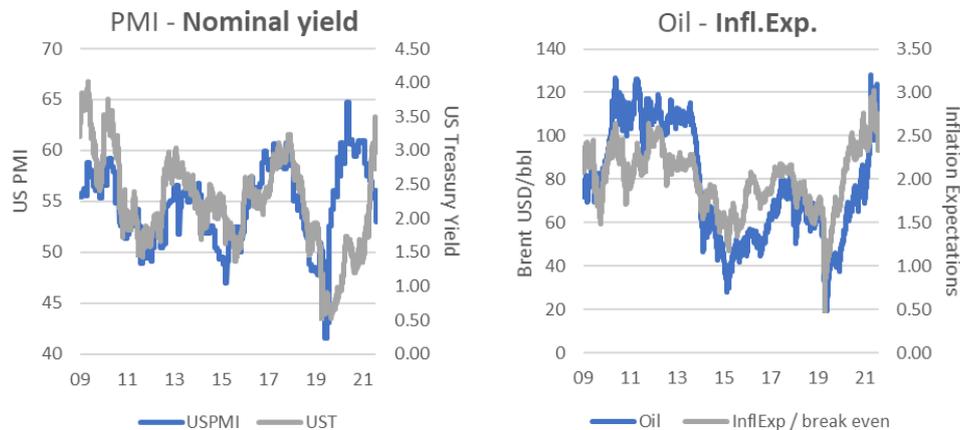
**Figure 2: Merlon bottom-up market valuation vs ASX200 level**



Source: Merlon

Having ground upwards from 1% to 2% over the course of 2021, US Treasury yields accelerated above 3% in less than 2 months in 2022. This spike came as the Fed removed its foot from the yield curve, having spent nearly USD5 trillion keeping it restrained while fiscal policy was allowed to stimulate the economy. Ironically it may be the economy that limits yields - at least in the near term - as the stimulus impulse fades and elevated energy prices and interest rates begin to curb economic activity. Yet even this effect may be fading, as inflation expectations have already begun to moderate, from above 3% in April, to 2.3% currently, as markets price in the contractionary impact of higher official rates and inflation itself.

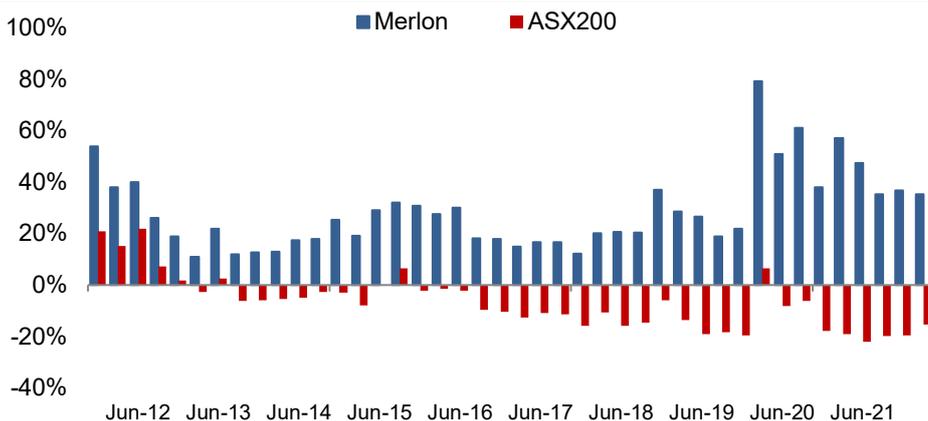
**Figure 3: Yield, inflation, and policy**



Sources: Federal Reserve of St. Louis. Institute of Supply Management. Bloomberg. Calculations: Merlon.

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

**Figure 4: Expected return based on Merlon valuations**



Source: Merlon

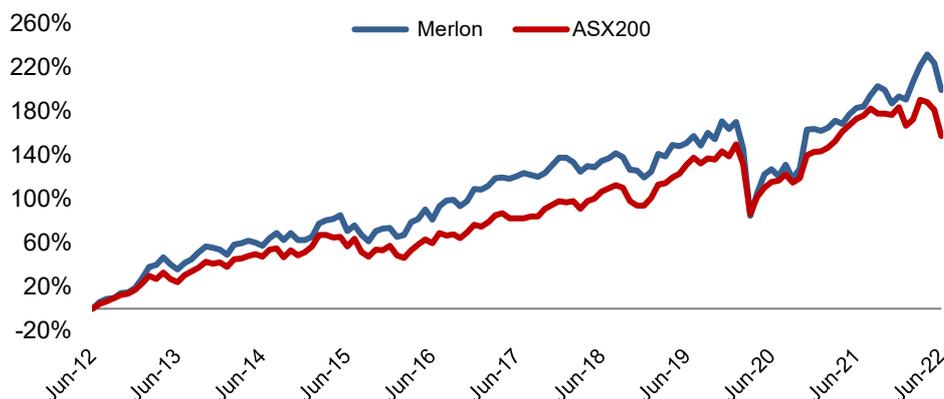
## Portfolio Review

Last quarter we noted the apparent valuation discount across Australian energy companies. This quarter saw some of that valuation gap closed as investors began to see the tightness evident in these commodities.

**Quarter:** At a stock level, the key contributors to the portfolio during the quarter were overweight positions in Ampol and Viva Energy, New Hope Corporation, Aurizon and QBE Insurance. Partly offsetting these contributions were underweight positions in CSL and Transurban, and overweight positions in Alumina, Insignia Financial, and Unibail Group.

**Financial Year:** The Portfolio also outperformed over the full financial year, driven by coal miners Whitehaven and New Hope, LNG producers Woodside and Origin Energy, and mid and downstream refiner marketer Ampol. Partly offsetting these contributions were underweight positions in BHP and overweight positions in Unibail Group, Insignia Financial, Super Cheap Retail and Southern Cross Media.

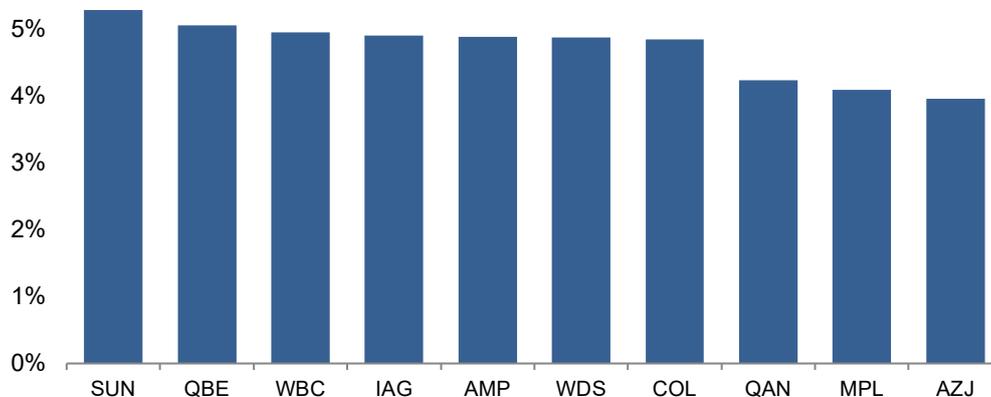
**Figure 5: Rolling ten-year returns (Concentrated Value Strategy)**



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

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	81%	0%
Merlon Valuation Upside	43%	-5%
Mid-cycle Free Cash Flow Yield	7.2%	5.1%
EV / EBITDA (year ahead)	10.4x	14.0x
Price / Earnings Ratio (year ahead)	11.7x	15.9x
Price / Book Ratio (year ahead)	1.9x	3.2x

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.

## Summary of key holdings



**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.



**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.



**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.



**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.

## Links to Previous Research

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[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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