Merlon Concentrated Australian Share Strategy

Monthly update – May 2024

MERLON CAPITAL PARTNERS

Strategy 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.

Strategy Performance gross of management fees

%[1]	Strategy	Benchmark[2]	Excess
Since Inception (p.a)[3]	11.8	10.0	1.8
10 Years (p.a)	11.1	9.2	1.9
5 Years (p.a)	11.8	9.1	2.7
3 Years (p.a)	15.5	8.2	7.3
1 Year	13.3	14.2	-0.9
CYTD	8.9	3.8	5.2
Quarter	1.1	1.6	-0.5
1 Month	-0.9	1.1	-2.0

[1]Performance figures are calculated before fees have been deducted and assume distributions have been reinvested. All returns are grossed up to include 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)

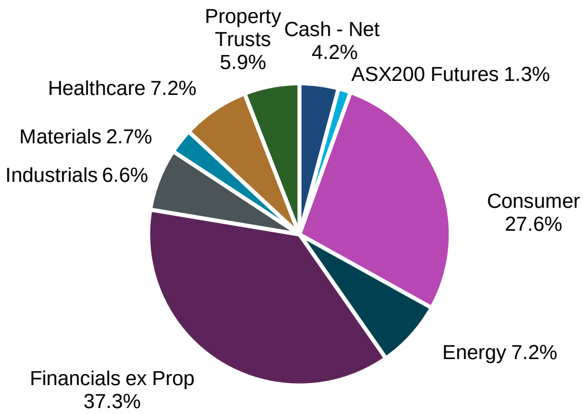
[3]The Strategy Inception date is 31 May 2010.

Source: Fidante Partners Limited, 31 May 2024.

Strategy Facts

Portfolio managers	Neil Margolis
Fund inception date	1st May 2017
Merlon FUM	$780m
Strategy FUM	$129m
Fund FUM	$129m

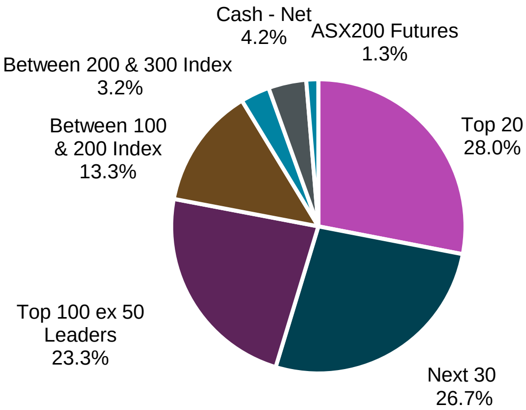
Sector Exposure



Top 10 Holdings (Alphabetical)

a2 Milk Co	Insurance Australia Group
AMP	QBE Insurance Group
ASX	Ramsay Health Care
Coles	Westpac Banking Corporation
Fletcher Building	Woolworths Group

Market Cap Bands - Fund



Monthly update

Despite some intra-month volatility, global markets moved higher in May with hopes that technological advances would continue to support rich valuations. While the Australian market moved higher (+0.9%) it lagged other global markets, with underlying stock earnings and macroeconomic data impacting sentiment. Despite the narrative around a soft landing continuing to resonate through the market, the Australian April CPI print showed the stubbornness of inflation, above expectations, and that led to a pullback in markets to end the month. Global markets were driven by different readings, with an increase in unemployment and in line CPI data in the US providing markets with the optimism they continue to seek that interest rate cuts might be imminent. There continues to be a balance between underlying company fundamentals and top-down factors, and there is no doubt that this will continue to drive volatility across the market.

May has traditionally been viewed as a ‘mini’ reporting season, with a number of major conferences providing companies with the opportunity to update the market on their earnings and disclose any changes in expectations. Woolworths (WOW) and Telstra (TLS) were two blue-chip darlings that disappointed the market during the month. WOW, which flagged to the market their view on changes in market sentiment dropped 4% in a day and TLS, who Merlon has observed struggling with their earnings / cashflow mismatch for a number of years, dragged the Communications Sector 2.5% lower on the back of their organisation changes.

Merlon underperformed by the market by 1.9% in May, with a number of separate stock stories impacting performance. Longer-term numbers continue to remain strong with 7.4% alpha delivered per annum over 3 years. During May, the main contributors to performance were positions in A2 Milk, Bendigo Bank and Star Entertainment Group, which were more than offset by negatives from positions in Fletcher Building, Ramsay Health Care and Tabcorp.

Market outlook and positioning

As has been the case for the last few years, the Merlon assessment remains that the market appears overvalued. Despite a fairly volatile year to date, the wider market valuation, based on Merlon’s bottom-up assessment of long-term cash-flow, discounted at mid-cycle discount rates, appears to neglect some of the imminent risks that exist. Importantly though, the Merlon portfolio continues to show upside, providing a strong buffer between the portfolio upside and the market overvaluation. We believe that this provides the opportunity for active management and strong excess investment returns over the long-term.

As mentioned previously, May was a month that experienced reasonable intra-month volatility. Interestingly this volatility was driven by both bottom up and top-down factors, displaying the challenge the market has had between evaluating fundamentals and trading on macro-led sentiment. While global markets reversed their April sentiment and gained confidence on the interest rate trajectory, the data coming out of Australia squashed many hopes for interest rate cuts, as inflation, which we have flagged for over 12 months, remains stubborn. While CY24 has shown the risks that continue to exist in the economy, some of which are being flagged by companies, such as WOW, the ‘melt-up’ in markets does show a willingness of market participants to look through these concerns. There seems little doubt that the inflation and interest rate trajectory will not be a straight line, and the flow on impacts on consumer spending and economic growth will impact the markets over the medium term. The question remains whether the market is willing to price in these genuine risks.

Merlon deliberately factors in long-term or ‘normal’ interest rates into our valuations, so any further uncertainty on interest rates does not impact how we value and rank companies, nor does it affect our estimates of what normal cashflows look like. This remains consistent with our long-standing investment policy and allows the team to look through much of the short-term noise and focus on the opportunities that are sustainable from a free cash flow perspective. As mentioned above, our focus on the bear case and downside takes into consideration the genuine risks that are prevalent for companies in the market, and even factoring this in, we continue to identify under-appreciated opportunities across sectors.

The Merlon portfolio comprises our best research ideas, based on our long-term sustainable cash-flow based valuations. Merlon continues to re-evaluate and trim stocks as they have outperformed, and the process guides the team to concentrated positioning in our best ideas. The normalisation of interest rates will take time to play out, and the conservative investment process employed by Merlon, combined with a consistent valuation method, means the portfolio remains appealing and positioned well for such an environment.