

Merlon Concentrated Australian Strategy

Monthly Report

July 2024



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
Strategy inception date	31 st May 2010
Merlon FUM	\$841m
Strategy FUM	\$158m
Fund objective	The Fund aims to outperform the benchmark on a total return basis over the medium to long term.

Fund Performance (before fees)

% ¹	Fund	Benchmark ²	Excess
Since Inception (p.a.)	10.4	8.8	1.6
10 Years (p.a.)	10.1	8.0	2.0
5 Years (p.a.)	11.3	7.5	3.8
3 Years (p.a.)	15.9	7.4	8.4
1 Year	13.2	13.5	-0.3
FYTD	5.1	4.2	0.9
CYTD	16.3	8.6	7.7
Quarter	6.0	6.2	-0.2
Month	5.1	4.2	0.9

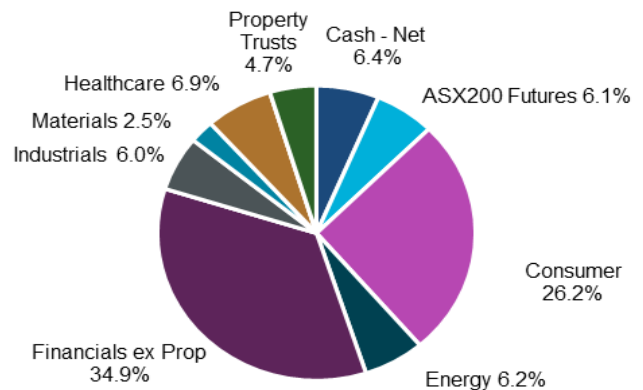
¹ Performance figures are calculated before fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures. Past performance is not a reliable indicator of future performance.

² The Fund benchmark is the S&P/ASX 200 Accumulation Index.

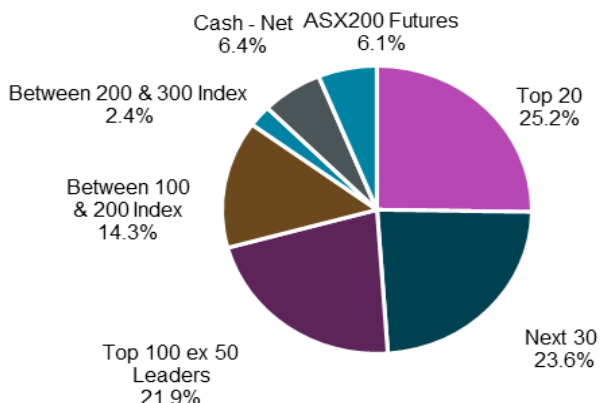
³ Strategy Inception date is 31 May 2010.

Source: Fidante Partners Limited, 31 July 2024.

Sector Exposures



Market Cap Bands - Fund



Top Ten Holdings (Alphabetical)

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

Performance update

Fund performance of 5.1% (before fees) in July was pleasing, outpacing the ASX200's 4.2% return. The index was weighed down by BHP and FMG, which we do not own, while our holdings in Insignia Financial, Star Entertainment and AMP were our largest positive contributors versus the index for the month. We recognise the discomfort that these names may create: this is exactly the point. Our investment process is designed to exploit behavioural biases: short-termism; recency bias and discomfort in holding unpopular views. In terms of detractors – the ASX200 was boosted strongly by both CBA and Wesfarmers which we do not own. Our holdings in Ramsay Health, Tabcorp and Treasury Wines were the key detractors versus the index for the month.

Global equity and commodity markets were mixed in July. Australian market strength was broad based, however it was once again led by the banks (up 7.1% in the month and up 38.4% in the 12 months to July) and consumer discretionary stocks (up 9.1% in the months and 30.9% over the last year). US equity markets were mixed, with the S&P 500 up 1.2%, and the Nasdaq down 0.7% for the month. In keeping with this, MSCI the Global Value Index was up 4.8%, while MSCI Global Growth fell 1%. Oil was weak over the month, with Brent down 6.6%, while thermal coal was up 5%. Gold rose 5.2% for the month, while the Australian dollar fell 1.9% versus the US dollar. Bonds were generally strong in major markets, with the yield on US 10 Year Treasuries falling 0.65% to 4.03%, and Australian 3 Year Government Bond yields down 0.28% to 3.76%.

In summary, markets globally appeared to show some fatigue with the US large cap tech, and there seemed some signs of a broadening rally away from tech into other sectors. This was widely discussed by strategists and market commentators. However, commodities, currencies and bonds did not appear to support the thesis that broadening performance in equity markets indicated general economic health. All this preceded a sharp correction in global markets at the start of August, driven in part by the unwinding of the yen “carry trade” – the practice of borrowing at low rates in yen to deploy funds in other assets. At the time of writing in early August, markets have stabilised and recovered a portion of the losses incurred in the carry trade unwind, and volatility has fallen, but remains elevated in both bond and equity markets.

Woodside has announced two acquisitions in recent weeks: that of US-listed Tellurian, in order to obtain the Driftwood LNG asset in the US for a total enterprise value of US\$1.2bn; and a low carbon ammonia asset from OCI for US\$2.4bn in cash. The former deal positions the company to access all major LNG markets globally, which has value as LNG pricing can see significant dislocation between markets. The low carbon ammonia asset purchase appears to rely on a significant premium in pricing for low carbon ammonia, achieved in this case by carbon capture and storage. Premium pricing for low carbon ammonia is possible, but the premium required to allow for reasonable project returns appears large.

We have been working on the gold producers in Australia, which we do not see as particularly cheap at present. We value businesses on the basis of sustainable or mid-cycle free cashflow. Gold companies tend to be poor allocators of capital and they tend to consume free cash in good times by lowering reserve grades and increasing unit costs as a result. Our process is to invest in undervalued companies where we think market participants have become too pessimistic. We will own gold companies when they rank favourably in our process, just as in the case of any other equity.

July saw the release of the 2024 Energy Institute Statistical Review of World Energy. Highlights in the 2024 update included that growth in demand for all carbon products (oil, gas and coal) remains positive; demand for oil has continued to grow in line with long-term trends; and there appears to be significant upside for nuclear should its use gain political acceptance globally.

The punishment of several prior market darlings has given rise to apparent value. This is an apt example of the Merlon process – our valuation and research discipline forces consideration of stocks toward which a traditional “value” manager may feel antipathy.

Market outlook and positioning

Our assessment remains that the Australian equity market appears overvalued. We arrive at this view via bottom-up analysis of long-term cash-flows generated by businesses, discounted at mid-cycle rates. The broad market is trading at a reasonable premium to our view of fair value and appears therefore to discount greater earnings growth than we see as likely, or else to reflect risk insufficiently. Our portfolio continues to show strong upside and is performing pleasingly. Of note is our positioning out of the Big Four banks. Our non-benchmark approach means we are not compelled to hold any company simply because it is large in the index. We do have some investment in the Big Four but only just over 5% in ANZ and WBC and have been reducing recently. The major banks have re-rated and performed strongly over the last year and do not appear attractive to us at present as a group, and they rank among the most expensive developed market banks globally.

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