Merlon Australian Share Income Fund

Quarterly Report - September 2024

For queries, please call Investor Services on 1300 721 637

Fund Features

Sustainable income: Paid monthly and majority franked. As the Fund's name suggests, sustainable above-market income is a targeted outcome of our investment approach and a key objective of the Fund.

Proven Investment Philosophy: We believe people are motivated by short-term outcomes, overemphasise recent information and are uncomfortable having unpopular views.

Portfolio diversification: The benchmark unaware approach to portfolio construction is a key structural feature, especially given the concentrated nature of the ASX200 index.

Downside protection: In addition to placing a heavy emphasis on capital preservation through our fundamental research, we use derivatives to reduce the Fund's market exposure and risk by 30% whilst still retaining all of the dividends and franking credits from the portfolio.

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 managers	Neil Margolis & Andrew Fraser
Fund inception date	30th September 2005
Merlon FUM	$838m
Strategy FUM	$672m
Fund FUM	$510m
Management fee	0.95% p.a
Fund objective[5]	The Fund aims to provide a higher level of tax effective income with a lower level of risk than the S&P/ASX 200 Accumulation Index, whilst also aiming to outperform the benchmark on a total return basis over the medium to long term.
Minimum Investment	$10,000
Suggested timeframe	At least 5 years
Buy/Sell Spread	+0.20% / -0.20%
Distribution Frequency	Monthly
APIR Code / ASX Code	HBC0011AU / MLO02

Top Ten Holdings (Alphabetical)

AMP	Insurance Australia Group
ASX	QBE Insurance
BHP Billiton	Ramsay Health Care
Coles	Westpac
Fletcher Building	Woolworths

Fund Performance (net of fees)

%[1]	Fund	Benchmark[2]	Yield[4]
Since Inception (p.a.)	7.7	7.5	9.3
10 Years (p.a.)	8.2	8.0	7.0
5 Years (p.a.)	8.5	7.6	6.5
3 Years (p.a.)	10.7	7.9	6.4
1 Year	14.2	17.4	6.3
FYTD	3.4	6.1	1.6
CYTD	11.7	10.4	4.7
Quarter	3.4	6.1	1.6
Month	1.9	2.4	0.7

[1]Performance figures are calculated after 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.

[2]The Fund's benchmark is a composite of 70% S&P/ASX 200 Accumulation Index / 30% Bloomberg Ausbond Bank Bill Index and is used for all time periods. From 30 September 2005 to 16 May 2022, the Fund's benchmark was the S&P/ASX 200 Accumulation Index.

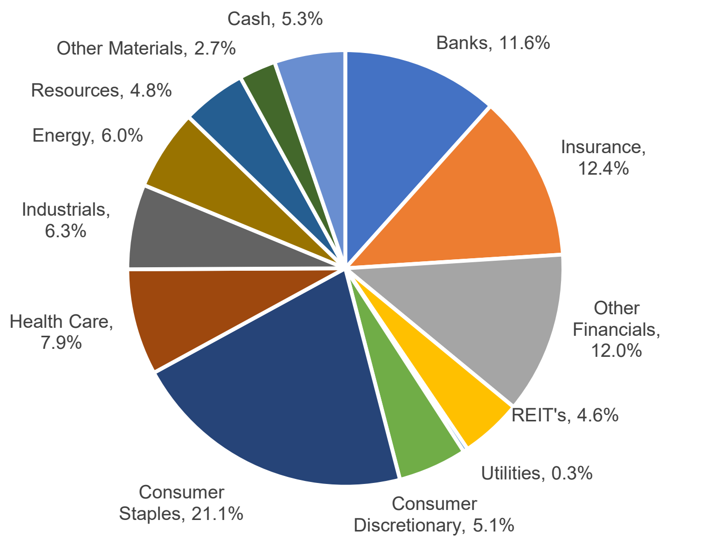
[3]The Inception Date for the Fund is 30 September 2005

[4] Yield represents the Gross distribution yield (inclusive of franking credits)

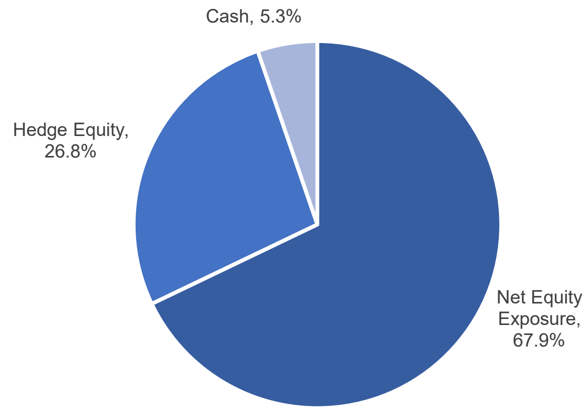
[5]In line with the Fund's benchmark change, the Fund's objective was also amended on 16 May 2022 to include a total return objective.

Source: Fidante Partners Limited, 30 September 2024.

Sector Exposures



Asset Allocation



Market Review

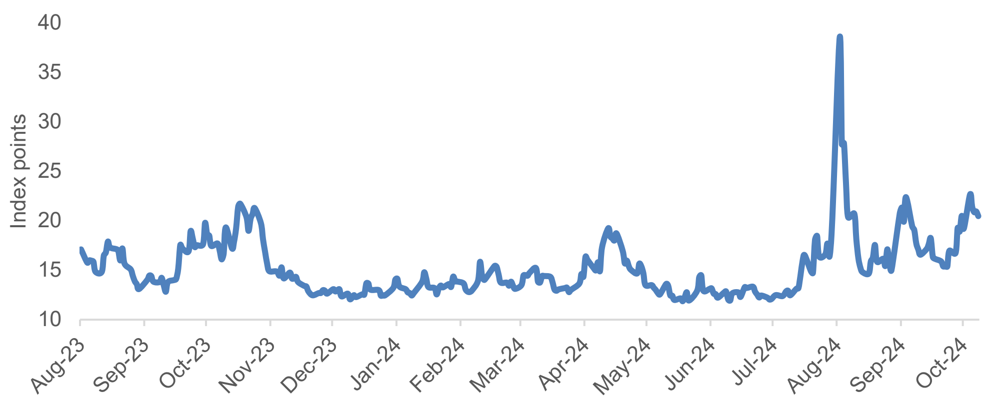
In the quarter to 30 September global equity markets were generally strong. The ASX 200 rose 6.5%, up in sympathy with Chinese equities. Stronger than expected stimulus measures in China saw Chinese stocks rise sharply in late September, up 11.5% for the quarter as measured by the Shanghai Composite. US equities were once again strong: the S&P 500 was up 5.5% and the Nasdaq up 1.9% for the quarter. European equities were up in general: the CAC 40 in France was up 2.1% in the quarter, while the more China-exposed German equity market, as measured by the DAX, was up 6.1%. The weakest major market was Japan, with the Nikkei 225 falling 4.2% over the quarter.

There was 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. This saw the single largest one-day fall in Japanese equities since 1989 – the Nikkei was down 12.4% on 5 August and implied volatility in US markets rose sharply, as measured by the VIX Index, which approached 40. Two months later this appears to be largely forgotten.

In early September global markets came under pressure again, led this time led lower by the US. Employment creation in the US was shown to have softened, with August's 142,000 jobs created disappointing markets, triggering single day declines of 2.1% in the S&P 500 and 3.1% in the Nasdaq. One month on, concern about the US economy softening appear also to be largely forgotten.

Global equity markets have displayed resilience to rising interest rates, gradually allowing economic growth and war, in the presence of high valuations, for the past 18 months or so. That said, implied volatility rose late in September, in part due to fears of escalation in the Middle East following a large and relatively sophisticated missile attack by Iran on Israel. At the time of writing in mid-October, US and global markets remain at or near all-time highs, with somewhat higher volatility than has prevailed for the last year.

Figure 1: S&P 500 Implied Volatility: the VIX Index



Source: TradeView

Commodities were generally solid over the quarter, with the exception of oil. Iron ore was almost unchanged at US$109.45/tonne for Singapore 62% Fe fines. The path to flat was interesting – a decline over the quarter amid ongoing Chinese economic doldrums, followed by a sharp rise at quarter end on the back of optimism regarding China.

Figure 2: Iron Ore, Singapore 62% Fines, CFR, US$/tonne

Source: TradingView. 1 July to 30 September 2024 shown

Copper was up 3.7% for the quarter and gold rose 12.7%. Crude oil, on the other hand, fell 16.4% for the quarter, before rising sharply after quarter end due to events in the Middle East.

The Australian dollar continues to trade in the range of 0.64 to 0.68 to the US dollar which has, by and large, prevailed since early 2023. The Aussie did see a brief excursion above 0.69 to the US dollar at quarter end, but this has faded toward 0.67 in early October.

Portfolio Review

Month:

The Fund underperformed the Benchmark by 0.5% during the month (after fees and including franking credits). Key performance drivers for the period were from the following positions:

Positive contributors:

A2 Milk bounced after selling off heavily in August, following a result that we regarded as in line, but which disappointed market expectations. Assistance to Chinese consumers as part of the country's stimulus measures were helpful for the company, given China is its largest market.

Other contributors included **Insignia Financial**, **Unibail** and **Orora**.

The Fund avoided declines in **CBA**, **CSL** and **NAB**, which detracted from ASX 200 performance.

Negative contributors:

Star Entertainment Group was a significant detractor over the month, after the stock opened following a long-awaited agreement with creditors.

Woolworths and **Coles** were both detractors from Fund performance, affected by the market's reaction to news of possible anti-competition sanctions around misleading pricing.

Rio Tinto, **BHP** and **Fortescue** were strong contributors to Index performance, which the Fund remains underweight.

Quarter:

The Fund lagged the Benchmark by 2.7% during the quarter (after fees and including franking credits). Key performance drivers for the period included the following positions:

Positive contributors:

Orora was the largest contributor to Fund performance over the month, benefiting from an approach by private equity which was rejected, and the sale of a business in the US.

AMP also contributed strongly over the quarter, following a reasonable result, which exceed very low market expectations. Further the company appears to have reached an outcome on its financial advice business via transfer of ownership to financial planning group Entireti. Similarly, **Insignia** Financial also contributed over the quarter – again market expectations for the business appear low.

Negative contributors:

Star Entertainment Group was a significant detractor over the month, after the stock opened following a long-awaited agreement with creditors.

Ramsay Health Care also detracted, as it continues to be best by what we think are cyclically depressed earnings and poor performance from its French business. The company is the low cost, scale provider of private hospital services in Australia and we believe there is genuine distress for other providers, indicating to us a significant chance of cyclical recovery over an investable timeframe.

Longer Term

The Fund has outperformed by 2.8% p.a. over three years, 0.9% p.a. over five years and since the Fund's inception (after fees and including franking credits). The Fund has also delivered on its objective to provide gross income above the ASX200 and less risk than the ASX200 since inception. Contributions over this period have come from a variety of sectors including Energy, Consumer, Health, Insurance and Utilities, demonstrating the flexibility of our approach, coupled with its disciplined implementation during more difficult periods.

Portfolio Activity

During the quarter we initiated a position in **Metcash**. Metcash is the leading wholesale distributor in Australia and services over 5,000 independent retailers in food, hardware and liquor. The business is unheralded, some would say unexciting, but it has a strong balance sheet, is cash generative and boasts ~20% returns on equity. The stock has been under pressure for months, allowing an attractive entry, in our view.

We also added health insurer **NIB Holdings** and funds management firm and deep value play **Perpetual**.

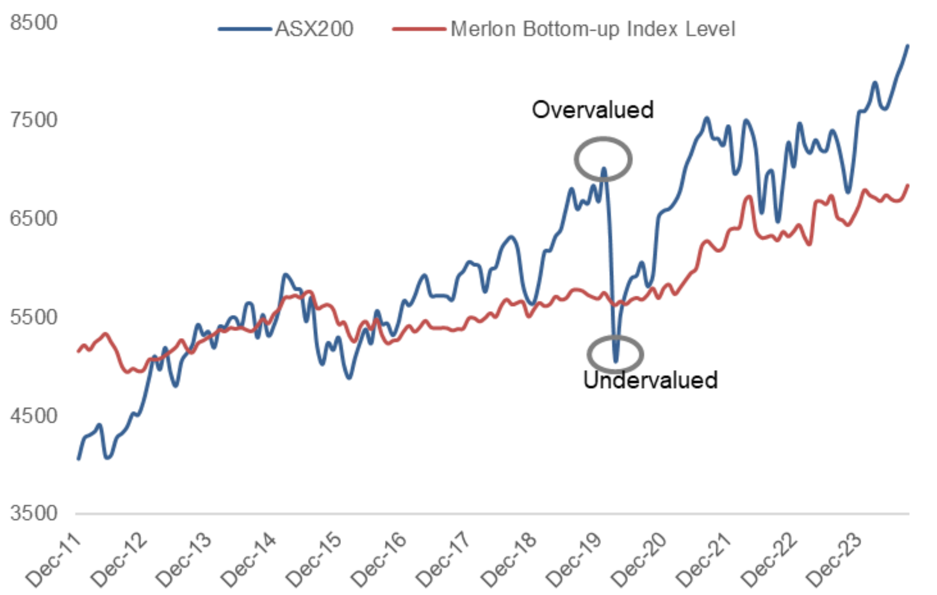
We exited **Alumina Ltd** during the quarter as the company was taken over. And we sold out of **JB Hi-Fi** as the stock appreciated beyond our upside case valuation.

We also reduced our positions in **Westpac** and **regional banks (Bendigo and Bank of Queensland)**.

Portfolio Outlook

As has been our historic practice, we continue to provide an aggregate assessment of the ASX200 valuation, based on the individual company valuations for the 150 stocks we actively cover.

Figure 3: Expected return based on Merlon valuations



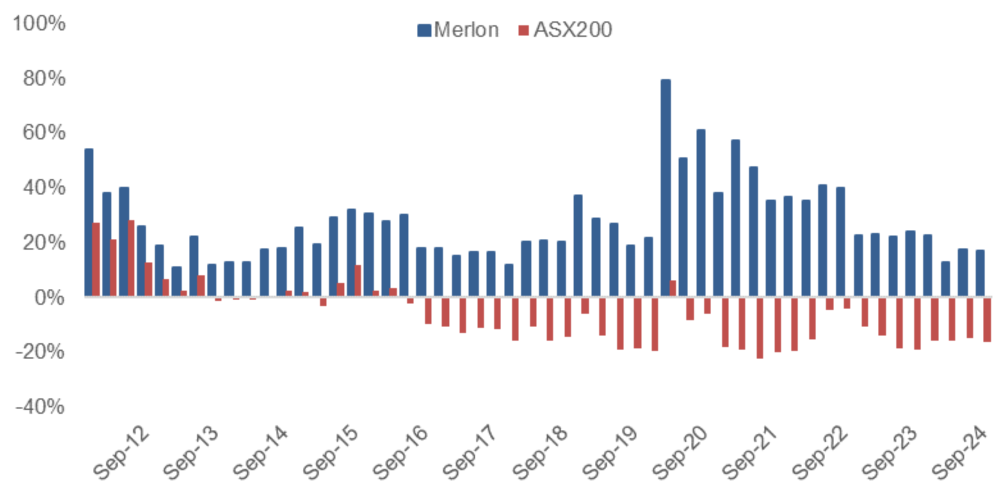
Source: Merlon Capital Partners

The portfolio reflects our best bottom-up fundamental views rather than macro or sector-specific themes. These are usually companies that are under-earning on a three-year view, or where cash generation and franking are being under-appreciated by the market.

While we are not macro investors, as discussed above there are clearly some macro themes inherent within the portfolio. We need to be aware of these themes and ensure they do not expose us or our clients to unintended or unbalanced risks. We seek to manage any such risks by our strategy of investing in companies that are under-valued and where investors have become overly pessimistic about long term prospects on account of weaker short-term performance. We assess the degree of pessimism by considering the company's market value in relation to a sensible valuation range with a particular focus on the downside risk scenario. Attractive valuations strongly imply that market concerns are – at least to some extent – already reflected in expectations and provide some "margin of safety" in the event conditions deteriorate.

As can be seen below, the Merlon portfolio continues to offer attractive upside as it has over the past 12 years, with the key being the expected return spread over the market. This gives us confidence we can continue to outperform over the medium and longer term.

Figure 4: Expected return based on Merlon valuations



Source: Merlon Capital Partners

As at the end of the quarter, the portfolio is relatively defensively positioned, with staples, diversified financials and health care being the largest sectoral exposures. We are heavily underweight banks, with approximately 6% in Westpac and ANZ, plus regional bank exposures, which we have been reducing in recent weeks.

While we are not macro investors, there are clearly macro themes inherent within the portfolio. We need to be aware of these themes and ensure they do not expose us or our clients to unintended or unbalanced risks. We seek to manage any such risks by our strategy of investing in companies that are under-valued and where investors have become overly pessimistic about long term prospects on account of weaker short-term performance. We assess the degree of pessimism by considering the company's market value in relation to a sensible valuation range with a particular focus on the downside risk scenario. Attractive valuations strongly imply that market concerns are – at least to some extent – already reflected in expectations and provide some "margin of safety" in the event conditions deteriorate.

The portfolio is positioned for an economy which "muddles through", with heavy exposure to defensive businesses in staples, insurance and diversified financials such as the ASX. We have an underweight in banks, but retain small, selective holdings in banks. We see challenging, but not outright recessionary conditions for consumers to navigate.

We are not inclined to add significantly to exposures in energy and resources, despite market excitement about Chinese stimulus. The measures announced so far are directed largely at Chinese consumers and the poor, in our view, with little in the way of blockbuster measures which would drive large increases in demand for iron ore and other commodities. This view is corroborated by declines in copper, met coal, iron ore and the Australian dollar after the initial exuberance of late September.

Worthy of special mention is lithium. We are cognisant of the sharp decline in lithium and spodumene prices in recent years. At current prices we believe lithium and lithium feedstock prices are "about right", amid significant excess capacity. Spodumene concentrate prices of US$750/t and lithium carbonate prices of US$10,000/t sit at approximately the top of the "necessary" cost curves, with excess capacity likely to be eliminated, but the industry should be able to maintain production supply at current prices.

This may form a floor for lithium prices, but we believe we are unlikely to see a return to above-cost-curve prices for lithium in the medium term – with significant capital deployed in Australia, Africa, South America and China in the industry.

Figure 5: Portfolio Analytics

	Portfolio	ASX200
Number of Equity Positions	33	200
Active Share	77%	0%
Merlon Valuation Upside	22%	-16%
Price / Earnings Ratio (year ahead)	17.2x	17.3x
Net Equity Exposure	68%	100%

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.

Stock in Focus

Fletcher Building (FBU) is a building materials manufacturer and distributor with operations predominantly in New Zealand and Australia. Its six divisions are Concrete, Building Products, Construction, Distribution, Australia and Residential/Land. Development.

To be a good investment, we need to understand the concerns that are driving a company to be undervalued by the market, and either prove these concerns are not valid or that the worst-case outcome is more than factored into the share price.

In addition to deep fundamental research and rigorous peer review, we have a formal engagement programme with the board of directors around the time of initial investment. We write a letter with the purpose of introducing Merlon, outlining our investment thesis, summarising key Environmental, Social and Governance (ESG) issues and ultimately achieving direct engagement with the company.

We believe the market has become overly concerned about the deteriorating building outlook in the face of high interest rates. We are confident that Fletcher's executive team will be able to "right-size" the cost base and reprice key products relatively quickly. We think that leading indicators have likely based. Against this, we remain cautious on the prevalence of legacy issues and expressly factor in substantial Iplex remediation costs to valuation scenarios.

Figure 6: Extract of letter to FBU Board

Members of the Board of Directors
Fletcher Building Limited
810 Great South Road
Penrose, Auckland 1061
New Zealand

Re: Introduction to Merlon Capital Partners

Ladies and Gentlemen:

For your records, Merlon Capital Partners ("Merlon" or "we") owns [redacted] shares in Fletcher Building Limited ("FBU" or "the company") on behalf of our clients, being retail and institutional investors. The purpose of this letter is to i) introduce Merlon to the board of directors; ii) outline our FBU investment thesis; iii) provide an overview of our approach to Environmental, Social and Governance (ESG) matters; and iv) summarise key ESG issues identified to date in relation to FBU.

Introduction to Merlon
Merlon is a high conviction fund manager. Subject to continued due diligence, when we initiate an investment position in a company our intent is to build the position into a significant proportion of our portfolios, which in turn also represents a significant proportion of our own personal wealth. In addition to direct alignment with our clients through co-investment, our firm is majority owned by our staff and we recognise investment performance over the long-term is critical to its success.

Investment Approach & FBU Investment Thesis
Our investment approach is to invest in undervalued companies where we think market become too pessimistic. In the case of FBU, we value the company at between NZ$3 security based on our assessment of midcycle activity levels. Our valuation is summarised

Segment	Low	High	Key Assumptions
NZ build products, steel, concrete & dist'n	$3.4b	$4.4b	Mid-cycle EBITD
Australia	$1.0b	$1.3b	Mid-cycle EBITD
Construction	Nil	$0.4b	Poor risk / return t
Land & development	$1.2b	$2.5b	15-25% ROIC
Associates	$0.2b	$0.5b	$15-30m profit co
Corporate costs	($1.3b)	($0.8b)	$50m-$80m annua
Onerous contracts	($0.3b)	($0.3b)	Current provision
Iplex liability	($0.5b)	($0.2b)	50% failure rate, $
Net debt	($1.4b)	($1.4b)	June 23 book valu
Imputation & franking credits	$0.1b	$0.1b	70% of face value
Equity value*	**$2.5b**	**$6.4b**	
Equity value per share	**$3.20**	**$8.20**	

*Numbers may not add up due to rounding

Source: Merlon Capital Partners

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Links to Previous Research

- Energy system stability: risks, opportunities & the decarbonised future
- 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