# Merlon Concentrated Australian Share Strategy

Monthly Report

October 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** | 31st May 2010 |
| **Merlon FUM** | $827m |
| **Strategy FUM** | $160m |
| **Fund objective** | The Fund aims to outperform the benchmark on a total return basis over the medium to long term. |

## Top Ten Holdings (Alphabetical)

| | |
|---|---|
| AMP | IOOF |
| ASX | QBE Insurance |
| Coles | Ramsay Health Care |
| Fletcher Building | Westpac |
| Insurance Australia Group | Woolworths |

## Fund Performance (before fees)

| %[1] | Fund | Benchmark[2] | Excess |
|---|---|---|---|
| **Since Inception (p.a.)** | 10.0 | 8.8 | 1.2 |
| **10 Years (p.a.)** | 9.6 | 8.3 | 1.2 |
| **5 Years (p.a.)** | 11.2 | 8.2 | 3.0 |
| **3 Years (p.a.)** | 13.1 | 8.0 | 5.0 |
| **1 Year** | 23.5 | 24.9 | -1.4 |
| **FYTD** | 3.0 | 6.4 | -3.4 |
| **CYTD** | 13.9 | 10.9 | 3.0 |
| **Quarter** | -2.1 | 2.1 | -4.2 |
| **Month** | -1.5 | -1.3 | -0.2 |

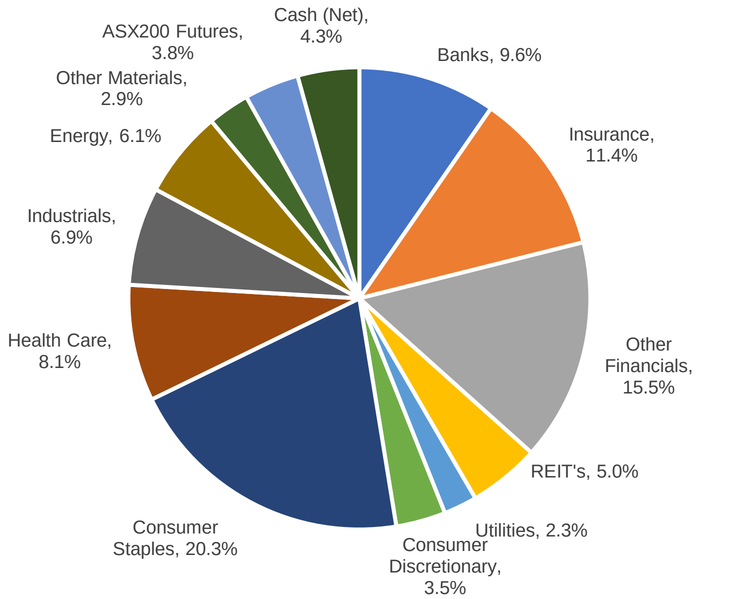
[1] Performance figures are calculated before fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures. Past performance is not a reliable indicator of future performance.

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

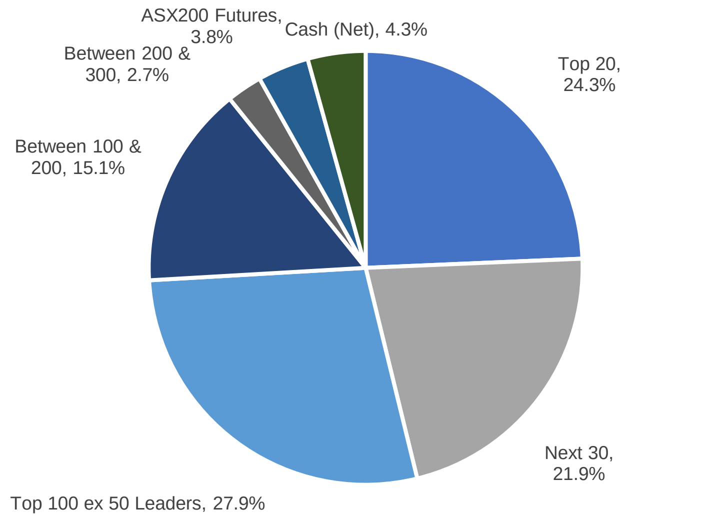
[3]Strategy Inception date is 31 May 2010.

**Source: Fidante Partners Limited, 31 October 2024.**

## Sector Exposures




## Market Cap Bands - Fund



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## Performance update

The portfolio lagged a weak ASX 200 in October, with our underweight banks position a major driver: in a weak month, ASX 200 banks were up 3.8%. Global equity markets were generally weak in October. Excitement about Chinese stimulus faded – the Shanghai Composite was down 1.6%. Investor uncertainty ahead of US elections may have weighed on their equity markets, with the S&P 500 down 0.9%. energy markets were weak, Brent, thermal coal and Henry Hub Gas all down, the AUD/USD fell 4.8%, but gold was up 4.2%. Currencies and commodities painted a risk-off picture in October. This was, of course, overshadowed by markets ripping following the conclusion of the US election in the first week of November.

Financial services firms AMP and Insignia were the largest contributors to performance over the month. Market expectations for both firms are very pessimistic in our view. Within AMP is an underearning, sub-scale bank with optionality to shrink in order to release capital, or sell if situation does not improve. There was speculation of just such a move – a $1.1 billion asset swap with Westpac – published in the Australian in early October. This may have helped draw attention to the value inherent within AMP, and its financial services peer Insignia (the old IOOF).

Woolworths was a significant detractor for the month, amid heightened regulatory risk and a disappointing market update that lowered margins versus market expectations. The US and UK have seen regulatory reviews of the retail sector, both of which seem to have been politically motivated and did little to change industry structure or affect industry profitability. We can't know the outcomes in Australia, but this seems a reasonable guide. Inflation is unpopular and large retailers are a useful political scapegoat, however margins and returns are no higher than pre-Covid. This is a good business, which we bought earlier in 2024, at share prices similar to those of today, on the basis of the market over-emphasising regulatory pressure and near-term margin pressure.

Orora was our largest detractor for the month, a victim of geopolitics. The European Union's decision to impose tariffs on Chinese electric vehicles, runs the risk of forcing China to retaliate. One obvious target would be high end wines and spirits of European origin…a key market for Orora. However, earnings expectations are muted versus our view of the mid-cycle earnings power of the business.

During the month we met with Ramsay Health Care management and toured company assets. It was clearly stated that no Ramsay hospital is making operating losses. This is important. The Department of Health review of the private hospital sector published on 1 November indicated that 45% of hospitals excluding Ramsay are posting operating losses (before interest and tax). We believe that Healthscope facilities are experiencing financial distress, and we have seen reports that various Catholic hospitals are refusing services to some privately covered patients for some procedures. All this serves as corroboration of our view that Ramsay is the scale and low-cost provider of an essential service, in an industry which is experiencing acute distress. We do not know exactly what the remedy is, but we are clear that Ramsay will survive, and that industry profitability will need to be restored in some way, which would greatly benefit Ramsay as the low-cost provider.

## Market outlook and positioning

Merlon's 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 significant premium to our view of fair value and appears to discount greater earnings growth than we see as likely, or else to reflect risk insufficiently. Our portfolio continues to show strong upside. It comprises our best research ideas, based on our long-term sustainable cash-flow based valuations.

The normalisation of inflation and consequent lowering of interest rates will take time to play out in our view. The portfolio remains appealing in terms of relative valuation, with a tilt toward "boring" businesses with pricing power, such as the large retailers, with a portfolio beta significantly below 1.