Merlon Australian Share Income Fund

Quarterly Report – June 2024

For queries, please call Investor Services on 1300 721 637

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.

Proven Track Record: Merlon's investment team has a proven track record of delivering true-to-label performance since its 2010 strategy 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 managers	Neil Margolis & Andrew Fraser
Fund inception date	30th September 2005
Merlon FUM	$791m
Strategy FUM	$652m
Fund FUM	$492m
Management fee	0.95% p.a
Performance fee	nil
Fund objective	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	HBC0011AU / MLO02

Top 10 Holdings (Alphabetical)

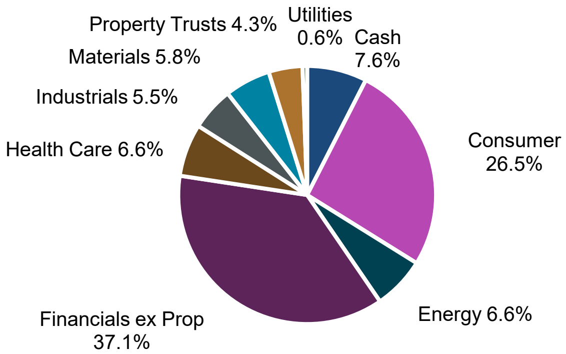
a2 Milk Co	QBE Group
ASX	Ramsay Health Care
BHP Group	Treasury Wine Estates
Coles Group	Westpac
Insurance Australia Group	Woolworths Group

Fund Performance net of all fees and expenses

%[1]	Fund	Benchmark[2]	Yield
Since Inception (p.a)[3]	7.6	7.3	9.3
10 Years (p.a)	8.2	7.4	7.1
5 Years (p.a)	8.6	6.8	6.5
3 Years (p.a)	11.3	6.4	6.5
1 Year	9.0	10.9	6.0
FYTD	9.0	10.9	6.0
Quarter	-1.8	-0.3	1.3
1 Month	1.4	0.8	0.4

[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 June 2024.

Sector Exposure



Quarterly value added relative to benchmark

Top 5	**Value Added (%)**
Insurance Australia Group	0.5
a2 Milk Co	0.4
Alumina	0.3
Fortescue	0.3
Bendigo and Adelaide Bank	0.3

Bottom 5	**Value Added (%)**
DEXUS Property Group	-0.3
ASX	-0.4
Ramsay Health Care	-0.5
Commonwealth Bank of Australia	-0.6
Fletcher Building	-0.8

Source: Fidante Partners Limited, 30 June 2024. Benchmark is S&P/ASX 200 Accumulation Index

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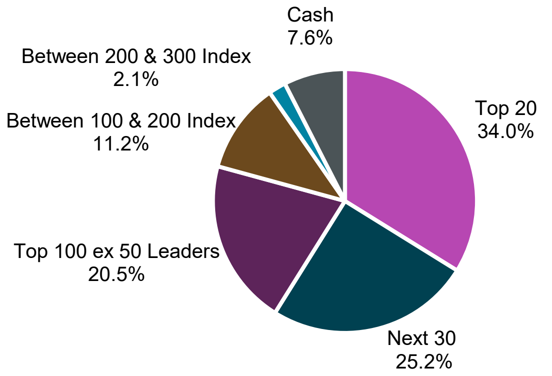
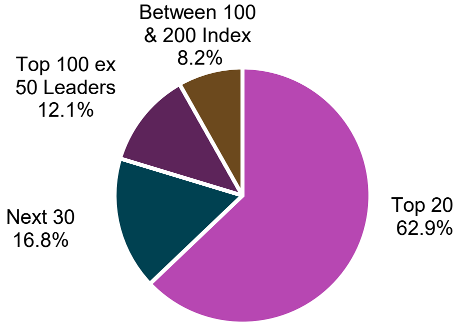
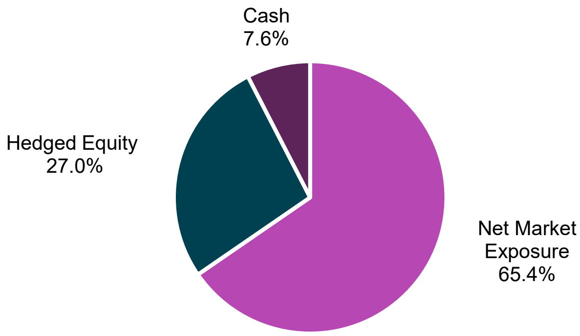
Market Cap Bands - Fund



Market Cap Bands – ASX 200



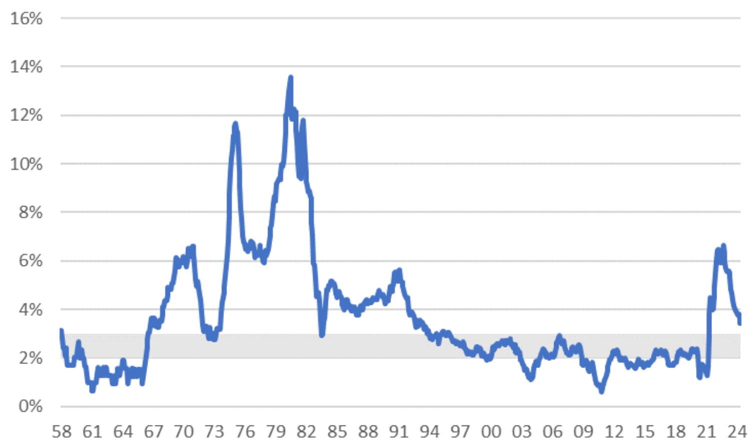
Asset Allocation



Macro Review

Much of the market's focus throughout the financial year has been following the rate of inflation decline. While markets were initially quick to price in a corresponding decline in official interest rates, a slowing in the pace of disinflation has seen these optimistic expectations moderate. In line with stickier than hoped inflation, US 10-year treasury yields rose by more than 50 basis points to finish the year at 4.36%, while inflation settled at an above-target 3.4%.

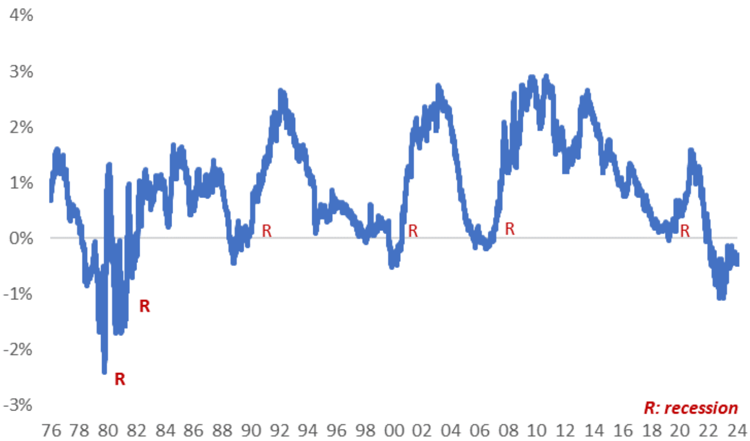
Figure 1: US core inflation rate



Source: Bureau of Labour Statistics. Calculations / Charting: Merlon Capital Partners.

Australian inflation has also disappointed, with a May print of 4.1%, leading markets to price in an even chance of a rate rise being the RBA's next policy move. As long noted in our reporting, it is likely to take longer than hoped for inflation to return to the 2-3% target rate. This is primarily due to the inflationary pulses that occur, with wage inflation currently catching up to goods and services inflation. It is yet to be determined whether this results in a second round of price hikes by businesses looking to manage margins, or whether labour is laid off. Demand strength will ultimately be the determinant of the path from here. The US, as an indicator, is not out of the woods if bond investors are to be believed, with the yield curve remaining in negative territory.

Figure 2: US yield curve

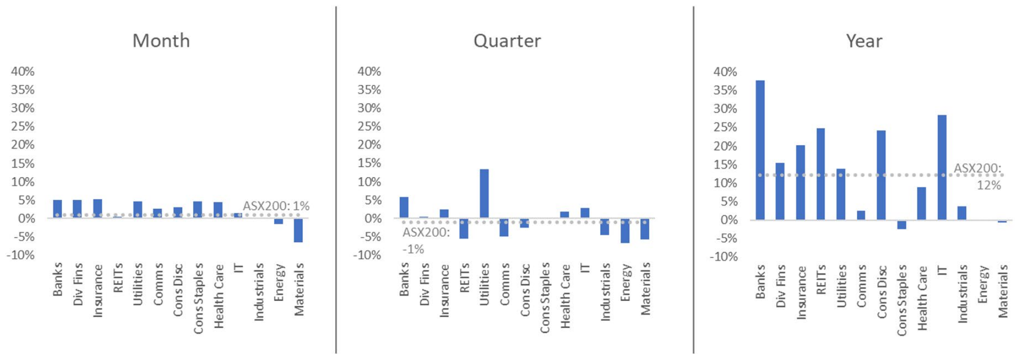


Source: Federal Reserve Bank of St. Louis. Calculations / Charting: Merlon Capital Partners.

Market review

The ASX200 rose by 1.0% during the month, finishing the month off its highs following a higher inflation reading and a corresponding sell-off as the market moved to increase its expectations of another rate rise. Despite the positive month, the June quarter finished down 0.8%, with broader expectations of lower yields impacting returns. The full financial year, however, delivered a strong return of 12%, in line with the strength seen in global markets.

Figure 3: sector returns

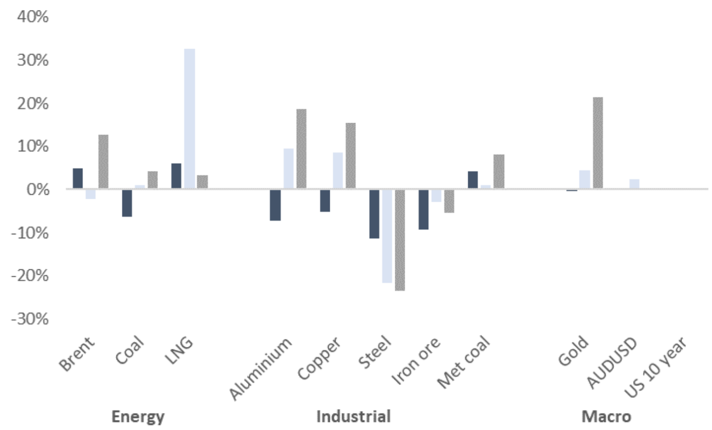


Source: Merlon Capital Partners, Bloomberg.

At a sector level, **Banks** performed best, driven largely by **Commonwealth Bank (CBA)**, while the Information Technology sector was strong, partly tracking the strength seen in US technology counterparts. Other positive sectors included **Consumer Discretionary,** reflecting low earnings expectations, **Insurance**, tracking lower claims and higher rates, and **REITs**, driven primarily by **Goodman Group (GPG)** on growing expectations of data centre warehouse demand.

The worst performing sectors over the year were **Materials**, led lower by weak iron ore and lithium prices, outweighing the positive gold sector. **Consumer Staples**, and **Healthcare**, all partly reflecting high premiums paid for defensiveness amidst a market starting to consider growth rather than defensiveness. And the **Energy** sector, underperformed the 13% return from oil, a commodity in tune with continually positive demand growth.

Figure 4: commodity and macro returns



Source: Merlon Capital Partners, Bloomberg.

Portfolio Review

MONTH: The Fund **outperformed the Benchmark by 0.5%** (after fees and including franking credits).

Positive contributors:

- **IAG (overweight):** continued to perform strongly on a late month confirmation of a large reinsurance agreement.
- **BHP (underweight):** continuing Chinese property weakness flowed through to lower demand for steel and iron ore.
- **FMG (underweight):** continuing Chinese property weakness flowed through to lower demand for steel and iron ore.

Negative contributors:

- **CBA (underweight):** continued its year-long rally and in turn, screens very expensive relative to domestic and global peers.
- **URW (overweight):** impacted by rate rise expectations as well as growing political instability in France.
- **NAB (underweight):** rallied throughout the year alongside CBA (above), albeit to a lesser degree.

Given the positive returns from the underlying share portfolio the risk reduction overlay detracted 0.5% from the Fund's returns during the month.

QUARTER: The Fund **underperformed the Benchmark by 1.6%** (after fees and including franking credits).

Positive contributors:

- **AWC (overweight):** Alcoa announced its intention to acquire AWC's 40% stake in Alcoa Worldwide Alumina and Chemicals.
- **IAG (overweight):** performed strongly, tracking lower claims rates and higher bond yields.
- **A2M (overweight):** delivered a strong first half result, upgraded full year sales guidance, and noted a stabilising formula market.

Negative contributors:

- **FBU (overweight):** impacted by the cyclical and product related issues, coupled with management and board turnover.
- **RHC (overweight):** cost-driven margin weakness across the sector, albeit subject to increasing risk of rationalisation.
- **CBA (underweight):** continued its year-long rally and in turn, screens very expensive relative to domestic and global peers.

During the quarter the risk reduction overlay added 0.8% to the Fund's returns, partly offsetting the fall in the value of the underlying share portfolio.

YEAR: The Fund **underperformed the Benchmark by 1.8%** (after fees and including franking credits).

Positive contributors:

- **CSR (overweight):** rallied strongly on the takeover by French company Saint-Gobain at the upper end of our valuation range.
- **URW (overweight):** rallied as the company delivered better than market expectations on portfolio rental income.
- **A2M (overweight):** delivered a strong first half result, upgraded full year sales guidance, and noted a stabilising formula market.

Negative contributors:

- **FBU (overweight):** impacted by the cyclical and product related issues, coupled with management and board turnover.
- **SGR (overweight):** was impacted by a combination of regulatory challenges, cyclical issues, and management turnover.
- **CBA (underweight):** rallied throughout the financial year, despite screening expensive relative to domestic and global peers.

Over the year to June 2024 the risk reduction overlay, which insulates the Fund from market downturns, detracted approximately 2%, inline with expectations given the Fund's 69% average daily net equity exposure.

LONG TERM: The Fund has outperformed the Benchmark by +4.9% p.a. over three years, +1.7% p.a. over five years and +0.8% p.a. over ten years (after fees and including franking credits).

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.

The Fund has also achieved a higher distribution yield than the ASX200 and substantially less risk than the ASX200 over three, five, ten years, and since the Fund's inception (30 Sep 2005)

Portfolio Activity (quarter)

Positions established / increased:

- **Orora Group:** a position was established as the company underperformed, increasing the valuation appeal in what is a high-quality company, with the market likely too pessimistic about what we expect are transitory cyclical factors.
- Existing positions in **Bendigo Bank**, **Ramsay Health Care, Woolworths, Insurance Australia Group, and Fletcher Building**, were increased on growing valuation appeal.

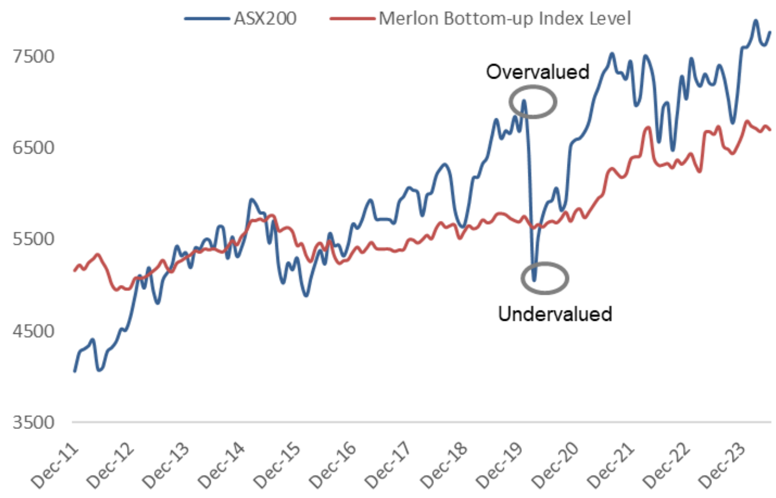
Positions exited / reduced:

- **CSR:** the position was exited following the takeover by French company Saint-Gobain at the upper end of our valuation range.
- Positions in **AWC** and **URW** were reduced following strong periods of strong performance.

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. Following the rally this year, the market could be up to 15% overvalued based on long-term discount rates.

Figure 4: Expected return based on Merlon valuations



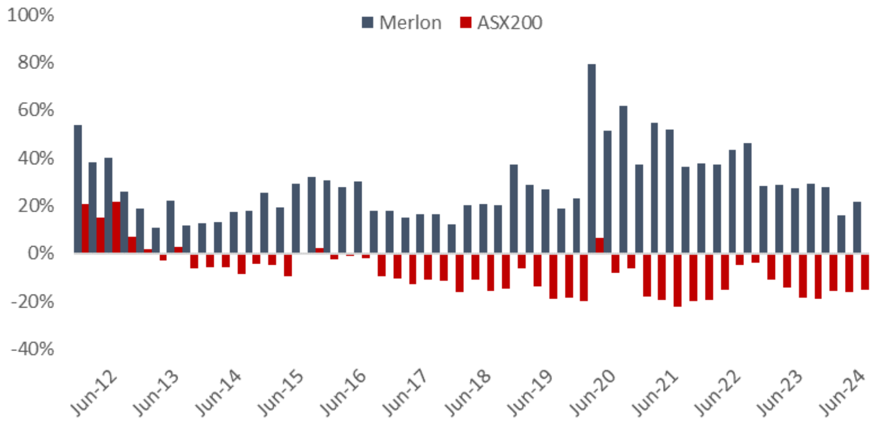
Source: Merlon Capital Partners

The portfolio reflects our best bottom-up fundamental views rather than macro or sector-specific themes. These are usually companies 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.

The Merlon portfolio continues to offer attractive upside as it has over the past 14 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 5: Expected return based on Merlon valuations



Source: Merlon Capital Partners

From a short-term perspective, inflation has decelerated and inflation expectations have rapidly moderated, however markets may not be adequately priced for persistently high and volatile inflation in our view. A pause in central bank rhetoric runs the risk of a reacceleration of inflation, with the longer inflation remains elevated comes the greater the risk of wage-price spirals. It is also unclear the extent of economic (and earnings) pain required to return inflation to central bank target levels. Furthermore, we have only recently ended 14 years of unconventional interest rate policy that has suppressed discount rates and inflated most asset values.

We believe our portfolio is well positioned, at least in a relative sense, if inflation proves more persistent as we focus on under-appreciated cashflow rather than longer dated growth potential at low discount rates and have consistently factored in higher (3%) real bond yields. These higher yields are consistent with history which extends beyond the period of central bank meddling with bond purchases and reflects a risk premium for inflation volatility.

Our portfolio is also well positioned, again at least in a relative sense, for an economic and earnings downturn. We are materially underweight late-cycle banks which are not pricing in the inevitable turn in the credit cycle and are now underweight commodity-exposed stocks (principally iron ore and now energy too) which will not be immune from the lagged global economic slowdown triggered by rapidly-higher interest rates. As we wrote about in our Covid Roadmap in 2020, leverage is the enemy in downturns and there are no more leveraged stocks than the banks, property and infrastructure stocks.

As it did in the most recent December 2023 quarter and during the 2017 to 2019 period, our portfolio might lag a strong market if central banks do an about-turn and engineer more record stimulus to push real bond yields back towards zero or below. Investors might consider this a risk worth taking in exchange for a portfolio of companies with absolute upside through a focus on cash generation, conservative approach to leverage and overly pessimistic market expectations, without needing assistance from lower real interest rates.

Figure 6: Portfolio Analytics

	Portfolio	ASX200
Number of Equity Positions	35	200
Active Share	70%	0%
Gross Yield	7.3%	5.1%
Merlon Valuation Upside	18%	-15%
Price / Earnings Ratio (year ahead)	16.3x	18.7x
Net Exposure	66%	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

Woolworths (WOW) is Australia's largest supermarket operator, with 1,400 stores across Australia and New Zealand, and operating in a highly concentrated industry structure.

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 value WOW at between $30/share and $42/share based on long-term assumptions and segment valuations. While government and media scrutiny surrounding the industry structure has continued since our initial investment, we believe the company will recognise the importance of a sustainable business model, and act accordingly. Having sought board engagement (see excerpt of letter below) and gained a fuller appreciation of the acquired business, we have continued to increase our position.

Our view is that the market is too pessimistic about the long-term impact of increased government scrutiny on supermarket pricing, over-emphasising the short-term earnings impact of high wage inflation and over-weighting the problems facing Woolworths New Zealand and Big W in the context of their minor contribution to the group's valuation.

In forming our view, we actively engage with market participants including other fund managers, proxy advisers, investment banking analysts and external ratings agencies as well as other relevant stakeholders to identify market views and concerns. In this way we seek to address the most important issues affecting each company with their board and drive deeper engagements.

Figure 7: Extract of letter to WOW Board

22 April 2024

Members of the Board of Directors
Woolworths Group Limited
1 Woolworths Way
Bella Vista, NSW, 2153

Re: Introduction to Merlon Capital Partners

Ladies and Gentlemen:

For your records, Merlon Capital Partners ("Merlon" or "we") owns [redacted] shares in Woolworths Group Limited ("WOW") 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 WOW 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 WOW.

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 & Woolworths Group Investment Thesis

Our investment approach is to invest in undervalued companies where we think market participants have become too pessimistic. We value all companies by capitalising our assessment of sustainable earnings at multiples aligned with free-cash-flow generation. In the case of WOW, we value the company at between $30 and $42 per security based on a range of long-term margin assumptions. Our valuation is summarised below:

Segments	Low	High	Key Assumptions
Australian Food	$35.2b	$45.6b	9.5 - 11.5% EBITDAR margin
Australian B2B	$0.7b	$1.2b	4.0 - 7.0% EBITDA margin
New Zealand Food	$2.9b	$4.1b	8.0 - 11.0% EBITDAR margin
Big W	NIL	$1.7b	6.0 - 10.0% EBITDAR margin
PetStock	$0.5b	$0.5b	Acquisition price
Unallocated	($0.2b)	NIL	Quantium, MyDeal & overheads excl EDV
Endeavour investment	$0.9b	$0.9b	Market value
Net Debt	($3.0b)	($3.0b)	Book value
Franking Credits	Nil	$0.9b	0 – 70% of face value
Equity value*	**$37.1b**	**$51.7b**	
Equity value per share	**$30**	**$42**	

*Numbers may not add up due to rounding

Source: Merlon Capital Partners.

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