

Merlon Concentrated Australian Share Fund

Quarterly Report – March 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	1 st February 2018
Merlon FUM	\$808m
Strategy FUM	\$145m
Fund FUM	\$145m
Management fee	0.52% p.a
Performance fee	20% of the Fund's daily return above the benchmark.
Fund objective	The Fund aims 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	Quarterly
APIR Code	HOW2217AU

Top 10 Holdings (Alphabetical)

a2 Milk Co	CSR
Alumia	Insurance Australia Group
AMP	QBE Insurance Group
ASX	Unibail Group
Coles Group	Westpac Banking Corporation

Fund Performance net of all fees and expenses

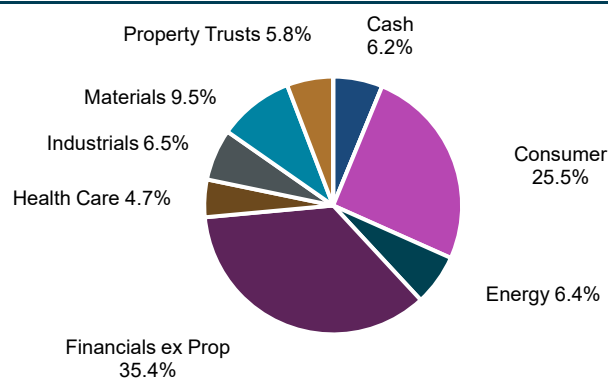
% ¹	Fund	Benchmark ²	Excess
Since Inception (p.a)³	8.8	8.6	0.2
5 Years (p.a)	11.2	9.1	2.1
3 Years (p.a)	15.3	9.6	5.6
1 Year	20.5	14.4	6.0
FYTD	13.3	13.3	0.0
6 Months	16.5	14.2	2.4
Quarter	12.8	5.3	7.5
1 Month	4.9	3.3	1.7

¹Performance figures are calculated after 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.

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

³The Inception Date for the fund is 1 February 2018. Strategy Inception date is 31 May 2010.
Source: Fidante Partners Limited, 31 March 2024.

Sector Exposure



Quarterly value added relative to benchmark

Top 5	Value Added (%)
BHP Group	1.8
a2 Milk Co	1.7
Alumina	1.6
CSR	1.1
AMP	0.9

Bottom 5	Value Added (%)
Commonwealth Bank Of Australia	-0.4
Healius	-0.4
Wesfarmers	-0.5
Goodman Group	-0.6
Fletcher Building	-0.6

Source: Fidante Partners Limited, 31 March 2024. Benchmark is S&P/ASX 200 Accumulation Index

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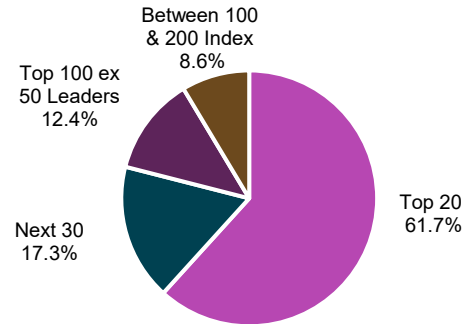
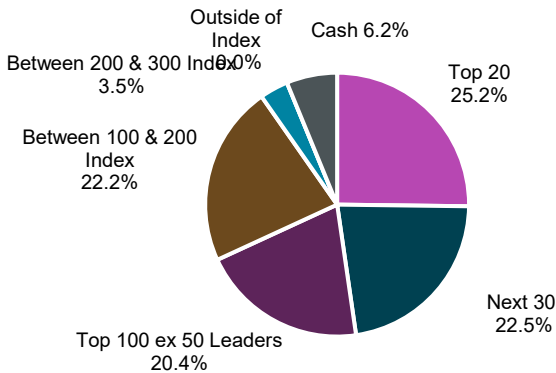
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Market Cap Bands - Fund

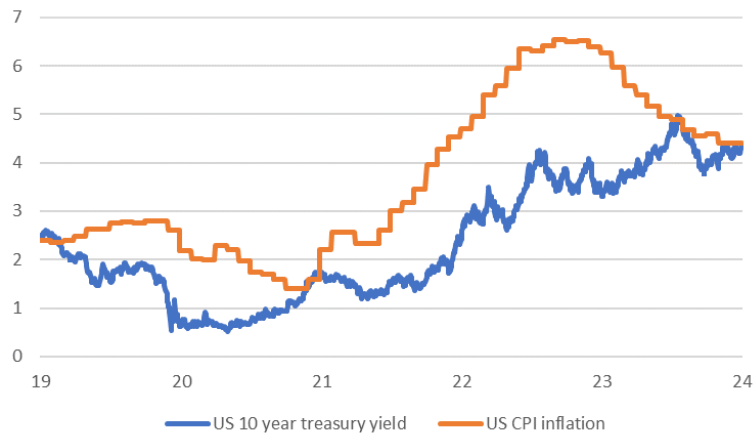
Market Cap Bands – ASX 200



Market Review

While US inflation continued to ease through the first quarter of 2024, its pace of easing appeared to moderate. In recognition of this, yields on US treasuries actually increased over this period, from 3.9% to 4.2%. And data more recently - from a strengthening manufacturing PMI to stronger jobs market - suggest an economy strengthening, despite prior concerns over the effect of the rapid, globally coordinated official rate rises designed to cool the economy, and in turn, inflation. If the US does in fact continue to strengthen, it could prove to be one of the only times the widely trusted recession indicator of an inverted yield curve was incorrect.

Figure 1: US treasuries vs inflation



Source: Merlon Capital Partners, Federal Reserve of St. Louis.

Market expectations for longer term inflation rates appear to have returned to a 'normal' level of 2.0-2.5%. This is to suggest a definition of normal that is above the 2015-2020 levels, a period corresponding to the ultra-low average risk-free rate of 2.5%.

The ASX200 rose strongly into 2024, recording a 3.3% rise in March to cap off a +5.3% quarter, with industrials outperforming resources by 15%. Within the resources sector, there was wide dispersion, with energy, based metals and gold exposed companies outperforming, while China exposed lithium and iron ore names underperformed.

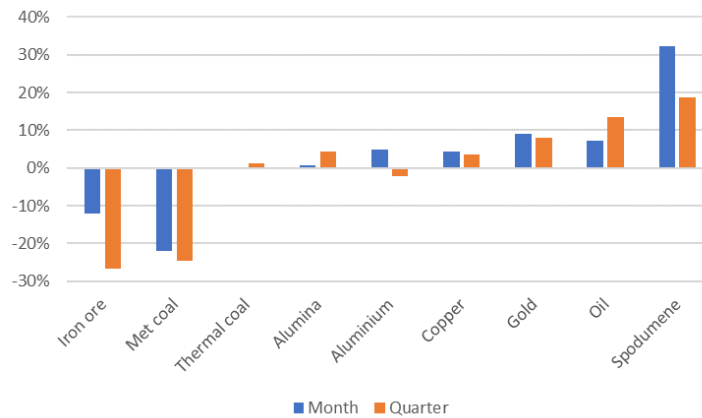
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Figure 2: commodity price changes

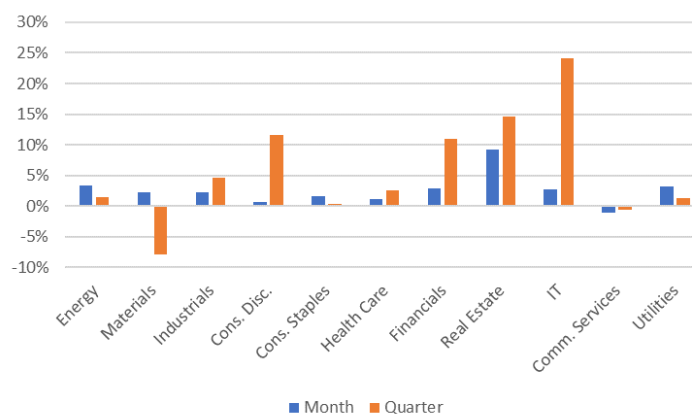


Source: Merlon Capital Partners, Bloomberg.

At a sector level, **Technology** performed the best, tracking the NASDAQ and bonds. Other positive sectors included **Consumer Discretionary**, reflecting low earnings expectations, **Insurance**, tracking lower claims and higher rates, and **REITs**, albeit most of the gains in the last quarter.

The worst performing sectors over the year were Materials, led lower by weak iron ore and lithium prices (see chart above), outweighing the positive gold sector. **Consumer Staples**, and **Healthcare**, all partly reflecting high premiums paid for defensiveness amidst a market starting to consider a growing economy as an increasingly likely scenario. And the **Energy** sector, while very modestly positive for the quarter, underperformed the 14% return from oil, a commodity in tune with the improved demand expectations.

Figure 3: sector returns



Source: Merlon Capital Partners, Bloomberg.

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Portfolio Review

Month: The Fund **outperformed the ASX200 by 1.7%** during the month. Key performance drivers for the period were from the following positions:

Positive contributors:

- **Alumina Limited (overweight):** rallied 34% as the takeover offer from parent company Alcoa of America was confirmed.
- **Unibail Group (underweight):** continued to rally as markets anticipated a basing of the global economy, and expectations of an easing interest rate environment.
- **a2 Milk (overweight):** continued to outperform following its positive result and outlook commentary (see below).

Negative contributors:

- **Goodman Group (underweight):** outperformed on expectations of an improving economic environment, and interest rate expectations shifting to the beginning of an easing cycle.
- **Fletcher Building (overweight):** continued to underperform following its poor result announced in February and management turnover (see below).
- **CSR (overweight):** having rallied by 30% in late February, following the takeover offer by French company Saint-Gobain, traded like cash in March, underpinned by the offer, while the ASX continued to rally on expectations of lower rates.

Quarter: The Fund **outperformed the ASX200 by 7.5%** during the quarter. Key performance drivers for the period were from the following positions:

Positive contributors:

- **BHP (underweight):** underperformed as the deteriorating Chinese property sector seen in 2023 flowed through to lower demand for steel and in turn iron ore.
- **a2 Milk (overweight):** outperformed as it delivered a strong first half result and upgraded its sales guidance for the full year. The company also noted expectations of a stabilising Chinese infant formula market.
- **Alumina Limited (overweight):** the company announced in early January that it had determined to shut the loss-making Kwinana refinery. Alcoa subsequently announced it intended to acquire the 40% share of Alcoa World Alumina and Chemicals (AWAC) that it does not own, listed in Australia as Alumina Limited.

Negative contributors:

- **Fletcher Building (overweight):** the underperformed following its poor first half result announced in February, with the company subsequently announcing the exit of its CEO and Chair.
- **Goodman Group (underweight):** was impacted by disruptions to its planned mining activities following a referral to the Environmental Planning Agency by the WA Forest Alliance.
- **Wesfarmers (underweight):** outperformed as the company's Bunnings and Kmart businesses continued to perform well, despite its nascent lithium business subject to declining selling prices, as was its fertilisers business.

Longer Term: The Fund has outperformed by 5.6% p.a. over three years, 2.1% p.a. over five years and 0.2% p.a. since the strategy's inception in 2010. 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.

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Portfolio Activity

Positions established:

- **Woolworths:** 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 the impact of government scrutiny on supermarket pricing.
- **Ramsay Health Care:** a position was established as we view the market as over-extrapolating the post COVID decline in operating margins, particularly given the company's exposure to a growing and ageing population.
- Small positions were also established in **Whitehaven Coal** and **Sonic Healthcare**, on growing valuation appeal, while we made additions to positions in **Treasury Wine Estates** (see Stock in Focus section, below) and **AWC** following its announced closure of the Kwinana refinery in early January.

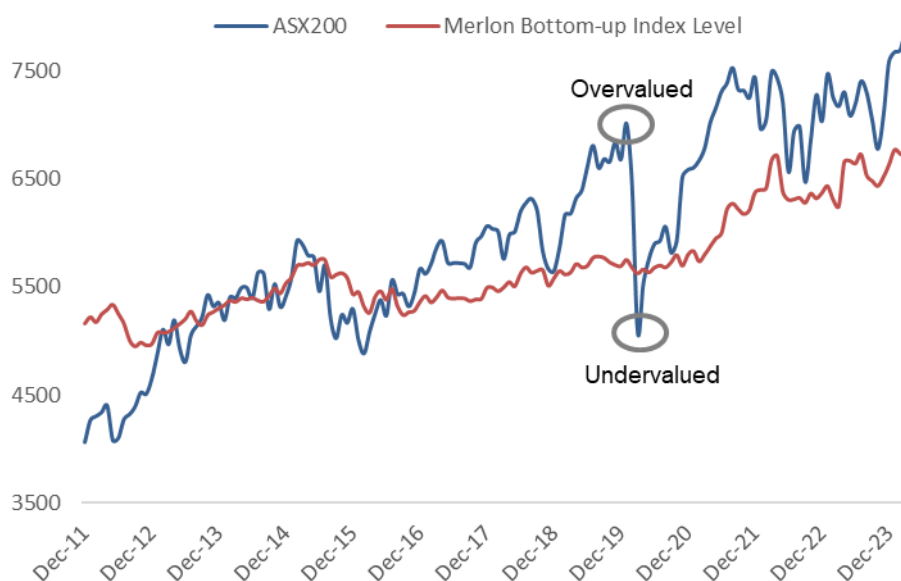
Positions exited:

- **News Corporation:** the position was exited following a period of strong outperformance, with the company trading above the upper end of our valuation range.
- **AGL:** the position was exited as the company appears likely to deliver declining earnings profile amidst post peak electricity pricing and appears determined to allocate capital into lower returning projects / acquisitions.
- Small positions in **Arcor**, **Super Cheap Group** and **Helix Group** were exited during the period.

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.

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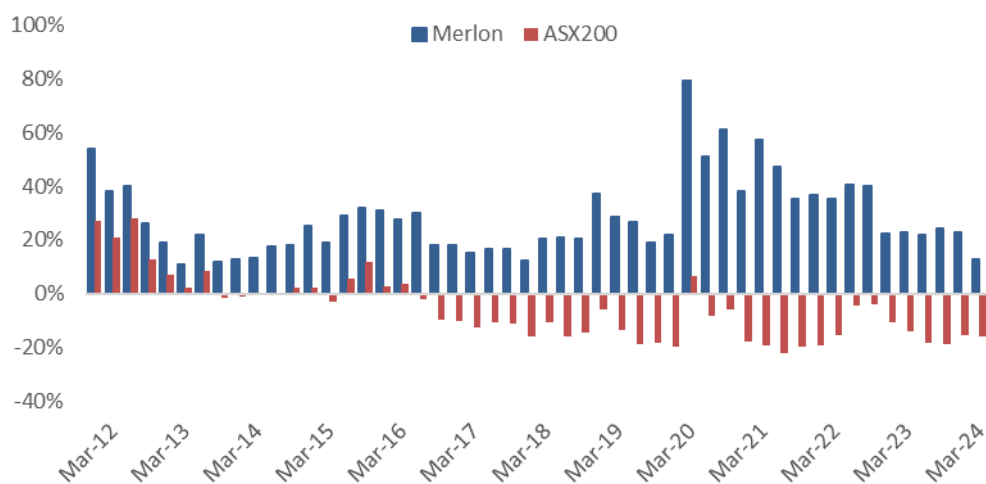


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While we are not macro investors, as discussed above there are clearly some macro themes inherent within the portfolio. We need to be aware of these themes and ensure they do not expose us or our clients to unintended or unbalanced risks. We seek to 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.

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Figure 6: Portfolio Analytics

	Portfolio	ASX200
Number of Equity Positions	31	200
Active Share	78%	0%
Merlon Valuation Upside	16%	-16%
Price / Earnings Ratio (year ahead)	18.1x	18.6x

*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.*

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Stock in Focus



TREASURY WINE ESTATES

Treasury Wine Estates (TWE) operates Australia's largest wine company, with 11,300 hectares of vineyards in servicing more than 70 countries and boasting one of the world's most highly regarded brands in its Penfolds label.

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 engaging directly with the company.

We value TWE at between \$8/share and \$17/share based on long-term assumptions and segment valuations:

While the shares have underperformed since our initial investment, in particular following its acquisition of the US based DAOU Vineyards, which underwhelmed the market. Having sought board engagement (see excerpt of letter below) and gained a fuller appreciation of the acquired business, we have increased our position.

In terms of regulatory risk, we acquired the shares when trading towards our low case valuation which we felt did not fully capture the anticipated impact of a lifting of Chinese tariffs on Australian wine imports (which occurred in March, with the company outperforming strongly).

Figure 7: Extract of letter to TWE Board



Investment Approach & TWE 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 TWE, we value the company at between \$8 and \$17 per security. Our valuation is summarised below:

Segment	Low	High	Key Assumptions
Penfolds "as-is"	\$4.0b	\$6.9b	40-50% EBITs margin
Chinese tariff removal	\$1.1b	\$4.1b	5-15% pa market growth since 2020 50-80% of 2020 market share
Treasury Americas	\$1.9b	\$2.4b	\$160m – \$200m EBITs opportunity
Treasury Premium Brands	\$0.8b	\$1.1b	\$70m – \$90m EBITs opportunity
DAOU	\$0.8b	\$1.6b	\$70m – \$130m EBITs opportunity
Corporate Costs	(\$0.8b)	(\$1.0b)	Based on 12 months to June 2023
Net Debt	(\$1.3b)	(\$1.3b)	Book value
Franking Credits	\$0b	\$0b	70% of face value
Equity value*	\$6.6b	\$13.7b	
Equity value per share	\$8	\$17	

*Numbers may not add up due to rounding

We think the market is underestimating the upside from a removal of Chinese wine tariffs. Partially offsetting this, we are concerned expectations for DAOU and Treasury Americas may be too optimistic.

Source: Merlon Capital Partners.

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