

On Point.

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MERCHANT WEST

Finance Invest Insure

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Note from the MD: Room to Disagree



Alyssa Viljoen

Asset management attracts clever people, and I mean that as a compliment. But it also creates a particular kind of risk. Clever people are very good at building a convincing case, and a convincing case is not always a correct one. Give a good analyst a company they like, and you will get a detailed model, a strong story and a price target that makes the decision feel obvious.

But the problem is we are not nearly as good at judging our own accuracy as we'd like to believe.

There was an interesting study by Duke University where, over more than a decade, researchers asked chief financial officers of US companies to forecast where the S&P 500 would be in a year's time. They also had to provide a range within which they were 80% confident the market would end up.

Across more than 13 000 forecasts, the market fell within that range just 36% of the time.

Think about that for a moment. These were senior finance professionals who were confident enough to put a range around their forecasts, yet the actual outcomes fell outside those ranges far more often than they expected.

Another example comes from Daniel Kahneman and his co-authors in their book Noise. An insurance company asked its underwriters to independently price exactly the same cases. Management expected some variation, perhaps around 10%. The actual difference was closer to 55%.

What I found particularly interesting was that the company hadn't realised how differently its own people were making the same decisions. Everyone was working independently, and there had never really been an opportunity to compare their thinking. (I suspect you would find something similar in quite a few investment teams.)

Typically, an analyst spends weeks researching a company and then presents a recommendation to the rest of the team. By that stage, there's already a fairly well-developed investment case on the table. The discussion often starts with that recommendation, rather than with everyone forming their own independent view.

And I think that distinction is important. Once somebody has presented a convincing argument, it's quite difficult not to be influenced by it, even if only subconsciously.

This is one of the reasons we've introduced something we call the dotplot at Merchant West Investments. It's actually a fairly simple exercise. Before we discuss a company as a team, everyone independently assesses two things: how attractive the valuation is, and the quality of the underlying business. The quality assessment draws on a SWOT analysis and our view of the company's competitive moat.

Each person's assessment is plotted as a dot on a chart. Nobody sees where anyone else has placed their dot until everyone has submitted their view.

What makes it useful is not necessarily where the dots end up, but how far apart they are.

Sometimes the team is broadly aligned. We all see a good-quality business trading at an attractive valuation, or perhaps a poor-quality business that's simply too expensive. There's probably not much value in spending another hour discussing something on which we already broadly agree.

But other times, the dots are scattered all over the chart.

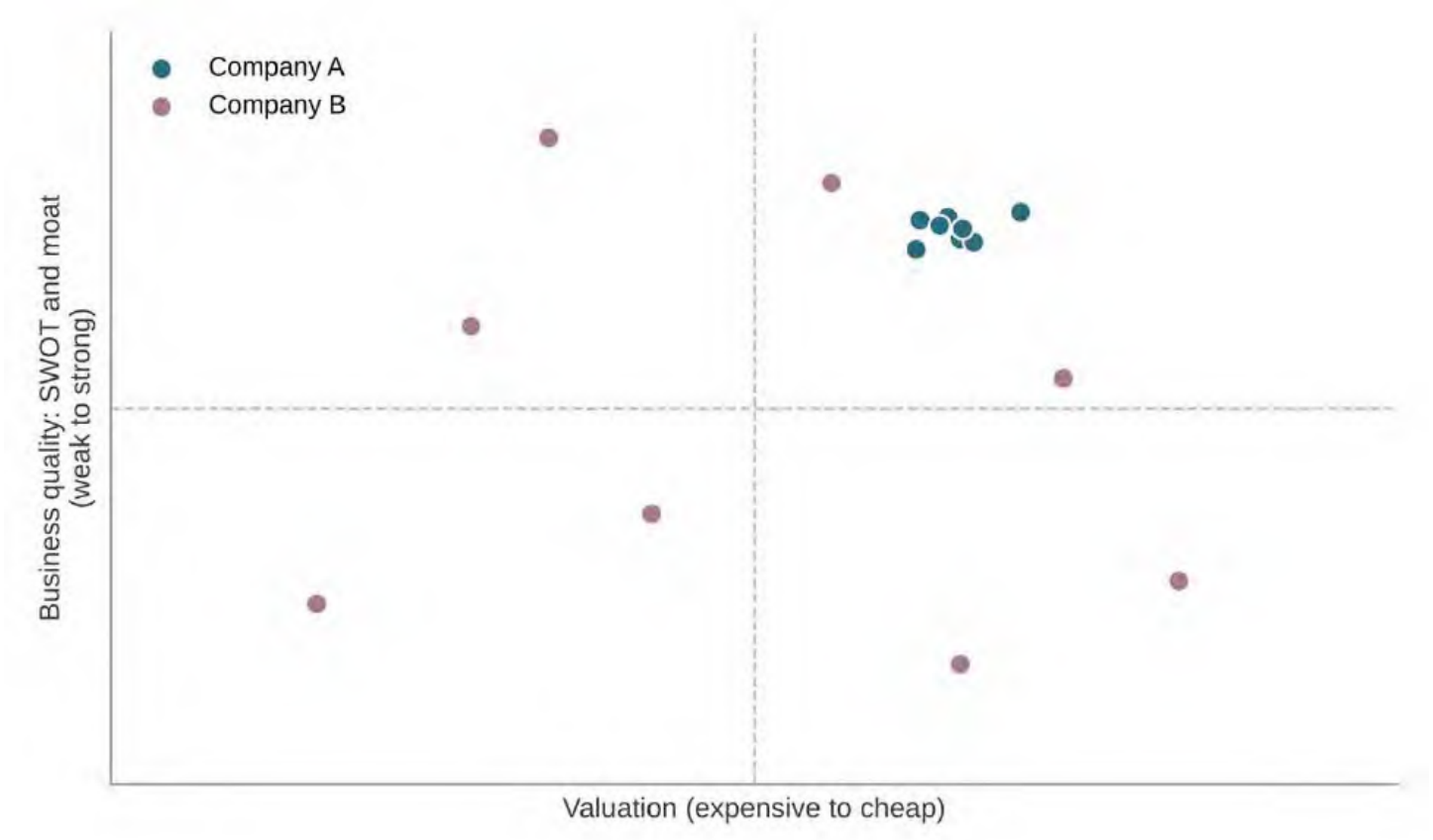
One person sees an excellent business, while another thinks its competitive position is deteriorating. One analyst believes the share is significantly undervalued, while someone else thinks the market is being far too optimistic.

That's when the conversation becomes interesting.

Instead of everyone debating a recommendation that has already been made, we're trying to understand why people who have access to much the same information have reached such different conclusions.

Quite often, it comes down to one or two assumptions that deserve a lot more attention. Perhaps we're making different assumptions about long-term margins, the sustainability of a company's competitive advantage, or the amount of capital it will need to grow.

And I'd much rather have those disagreements before we've invested our clients' money than afterwards.



Illustrative example of the dotplot. Each dot is one team member's independent view. On Company A the team broadly agrees; on Company B views are spread widely, which is where the debate goes. Not actual holdings or team assessments.

None of this is investing by committee. If you need everyone to agree before you act, you end up owning only the obvious ideas, and those are usually already in the price. The portfolio manager still makes the decision and is accountable for it. What changes is that the decision is made knowing where the disagreement lies. That record matters, because it lets us look back and separate a good decision from a good outcome. Some sound decisions lose money, and some poor ones work out, and without a record it is very easy to learn the wrong lesson from both.

When you're taking an active position, I think it's important that clients know those decisions have been properly tested. Not just that somebody has a strong view, but that the view has been questioned by people who are equally capable of reaching their own conclusions.

And looking ahead, I suspect this will only become more important.

It is also likely to matter more over time. Information is becoming cheaper and easier to access. With AI, investment managers can now process enormous amounts of research, financial data and company information in a fraction of the time it would previously have taken.

That's a good thing, but it also means that access to information is becoming less of a competitive advantage. Almost anyone can produce a fairly convincing investment case with the right tools.

What will matter is how we interpret that information, the assumptions we make and, importantly, whether we're prepared to challenge our own thinking.

I don't expect our team to agree on every investment. In fact, I'd be a little concerned if they did.

I'd much rather have a room full of people who are comfortable disagreeing with one another. Because ultimately, the objective isn't to win the debate around the table. It's to make better decisions with our clients' money.

Letter from the Chief Investment officer

The right kind of diversification

Lowering risk without sacrificing returns



Raymond Shapiro

"When you diversify, you have to remember, it's not having a number of things. It's having things that respond differently to a given situation."

– Howard Marks, co-founder of Oaktree Capital

Every investor wants higher returns and lower risk. Usually, that is a trade-off: to reduce risk, you accept lower returns. There is one well-documented exception. Combining good investments that do not move together lowers a portfolio's risk without lowering its expected return.

Applying this principle deliberately is central to how we are building our portfolios today.

Correlation – simple but powerful

A portfolio's expected return is the weighted average of its holdings' expected returns. Its risk is not. When holdings respond differently to events, their ups and downs help counterbalance each other, so the portfolio swings less than its individual parts. The less holdings move together – that is, the less correlated they are with each other – the greater the risk reduction benefit.

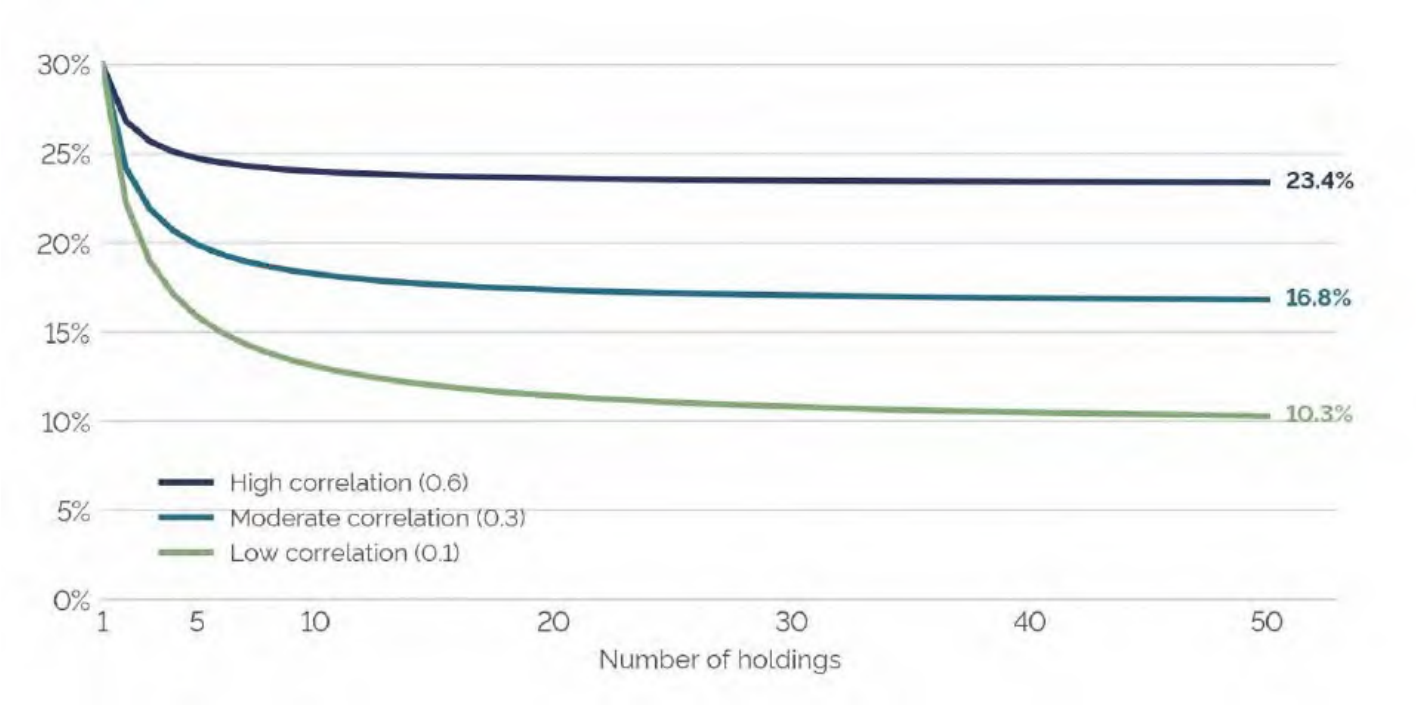
What matters is how holdings move, not how many there are. Nobel laureate Harry Markowitz, father of modern portfolio theory, made the point in 1952:

"A portfolio with sixty different railway securities, for example, would not be as well diversified as the same size portfolio with some railroad, some public utility, mining, various sorts of manufacturing, etc. …it is not enough to invest in many securities. It is necessary to avoid investing in securities with high covariances among themselves."

– Harry Markowitz, "Portfolio Selection", The Journal of Finance (1952)

Exhibit 1 provides an illustration. Even a handful of lowly correlated holdings can carry far less volatility than many highly correlated ones: five holdings with a correlation of 0.1 are less volatile than fifty with a correlation of 0.6. Adding lower-correlation holdings to a portfolio reduces risk on several fronts at once. Volatility, the size of a portfolio's swings, falls. Drawdowns tend to be shallower and concentration risk, the danger of one theme driving everything, shrinks. Importantly, behavioural risk falls: a smoother ride makes it far easier to hold one's nerve rather than sell at the bottom.

Exhibit 1: Lower correlation, lower risk.
Portfolio Volatility by Number of Holdings
(Annualised volatility, %)



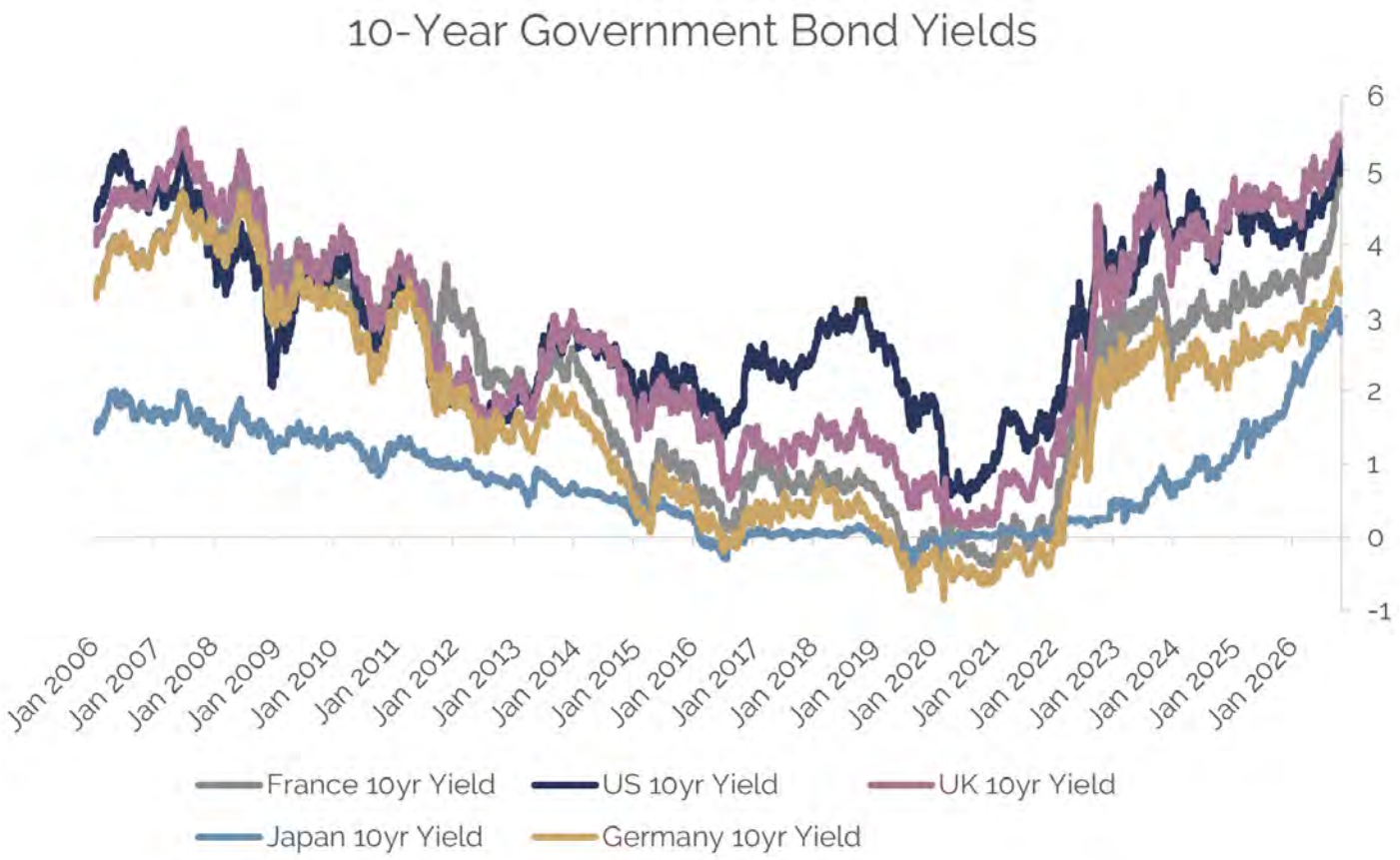
Source: Merchant West Investments. Illustrative calculation for an equally weighted portfolio in which each holding has 30% annualised volatility and every pair of holdings shares the correlation shown. Portfolio volatility = × √ (1/N + (1 − 1/N) ×), where is each holding's volatility, N the number of holdings and the correlation. Not a forecast of any fund's risk or return.

The current context

While the case for lower-correlation holdings is timeless, today's conditions make it especially important. As I noted in my August letter, we estimate AI-driven stocks now make up roughly 40% of global equity benchmarks. This makes markets very vulnerable to a single, uncertain and volatile driver. In addition, we are eight months into a US-Iran conflict, which is keeping the oil price at an elevated level for an uncomfortably extended period. US inflation is running hot, partly as a result, and in September the US Federal Reserve raised rates for the first time since 2023.

Perhaps most importantly, long-term government bond yields in several developed nations have surged (Exhibit 2), on fears of stubborn inflation, overindebted governments and excessive deficit spending, as well as competition for borrowing from the private sector to fund a massive AI infrastructure buildout. This has resulted in long rates reaching their highest levels in over 20 years in some cases. These yields form the cornerstone of the cost of capital (debt and equity) across the globe. As the cost of capital rises, valuations are naturally compressed – unless growth increases to offset the drag. Furthermore, some $4.3 trillion of US non-financial corporate bonds, much of it issued at rock-bottom pandemic-era rates, matures between 2027 and 2031. Should rates not fall materially by then, many corporates will face significantly higher borrowing costs, pressuring profits.

Exhibit 2: Government bond yields have surged across the developed world.
10-Year Government Bond Yields (%)



Source: Bloomberg

Reducing risks, retaining returns

Given the current investment context, to intelligently manage risk we have been deliberately adding businesses with low correlation to the general market, and thus, largely, to the AI investment driver as well, to which we also have exposure. The proviso is that each additional holding must itself be a good long-term investment. Cutting risk by owning lower-returning assets is easy, and costly. Intelligent diversification is not a simple retreat into traditional defensives such as consumer staples and pharmaceutical businesses. Their steady, predictable cash flows mean they are often owned as "bond proxies" and tend to trade like long-dated bonds: when the cost of capital rises (as it is now), their valuations come under pressure, because their modest growth cannot easily offset the higher cost of capital and debt. Despite this, a flight to safety has left many defensives trading at valuation premiums, a drag on future returns. For this reason, we own defensives selectively, and only when they offer suitably attractive long-term returns.

In addition to having a low correlation to the market and other holdings in the portfolio, we look to select businesses offering attractive long-term growth prospects, the ability to grow through tough times, low gearing and, ideally, the ability to benefit from higher rates.

CME Group, the world's dominant futures exchange, is a good example of a stock we have added, possessing the attributes we are looking for. As my colleague Joshua Viljoen explains in his article "CME Group: The Toll Road on Risk", it earns a fee on every contract traded, whether markets rise or fall. Turbulence brings more hedging and higher trade volumes, and higher rates boost what it earns on some $146 billion of client cash collateral. Its daily correlation to the S&P 500 has been below 0.2 over the past five years. The company benefits from volatility.

Another example is McKesson, another stock with very low correlation to the general market. The company distributes around a third of America's prescription medicines. People do not stop taking blood pressure tablets because AI stocks fall. Its revenue has grown in each of the past ten years, and suppliers fund around $7.8 billion of its working capital: interest-free financing that is worth more as money gets dearer, as Bianca Lakha's recent piece, "Thin Margins, Thick Cash", explains.

A third example is MTU Aero Engines, the subject of Neal Hoogwerf's article "MTU Aero Engines: Long-Duration Economics, On Sale". MTU designs and builds key sections of jet engines and is the world's largest independent engine maintenance provider. Its earnings are driven by the hours its engines fly and regulatory requirements, not by data-centre budgets. It generates revenue from long-term service agreements, typically paid at a fixed rate per flight. MTU provides a long duration return stream with unique long-term drivers very different from those dominating markets today.

Furthermore, property and casualty insurers we own such as Progressive, Kinsale, Admiral, Fairfax and, locally, OUTsurance sell non-discretionary cover and invest the premiums they hold until claims are paid, with higher yields lifting their investment income.

Each stock mentioned earns its keep from its own specific drivers: risk transfer, volatility, healthcare, flight hours and even higher interest rates, not data-centre budgets. They are conservatively financed and largely shielded from AI-driven market weakness. However, many are likely to be unrecognised future beneficiaries of AI, using it to price risk, predict engine wear, run leaner logistics and cut costs.

This does not mean we do not own or have exposure to AI-driven stocks, rather that we choose to diversify by owning multiple, less correlated return streams that can deliver attractive returns under different conditions and contexts.

Quality, but not at any price

In the current climate it is worth emphasising that investing in quality businesses naturally controls risk. Businesses with pricing power, high returns on capital, strong cash generation and conservative balance sheets are rarely forced into bad decisions at bad times. Notwithstanding, quality is not a licence to overpay. Valuation discipline is itself a critical risk management tool. This we believe is one of our key differentiators – quality, but at the right price.

Sir John Templeton warned that "no matter how careful you are, you can neither predict nor control the future." That is why we never build portfolios for one outcome or one big bet. Owning strong, attractively priced businesses that behave differently is how we aim to lower risk in all its forms, while keeping long-term returns intact.

Thank you for your continued partnership and trust.

Sources: Howard Marks, 3 Takeaways podcast with Lynn Thoman, 30 March 2021. Harry Markowitz, "Portfolio Selection", The Journal of Finance, Vol. 7, No. 1 (1952). Sir John Templeton, "16 Rules for Investment Success", World Monitor (1993). AI index weight, Merchant West Investments calculations (Letter from the CIO, August 2026). US CPI, Bureau of Labor Statistics (September 2026). FOMC decision, 16 September 2026. Treasury, gilt and JGB yield milestones, Reuters, CNBC and LSEG data, September–October 2026. US non-financial corporate bond maturities, Reuters analysis of LSEG data, 25 September 2026. CME Group Q3 2026 results (21 October 2026) and September 2026 volume release. CME correlation, McKesson and MTU data, Merchant West Investments research: "CME Group: The Toll Road on Risk", "Thin Margins, Thick Cash: Why we like McKesson" and "MTU Aero Engines: Long-Duration Economics, On Sale".

Rent cheques and resilience: why SA REITs earn their place in the Merchant West SCI Balanced Plus Fund



Ian Anderson

Why we are talking about property again

The Merchant West SCI Balanced Plus Fund currently holds 6% of its assets in a deliberately small group of seven South African REITs: Dipula, Fairvest, Growthpoint, Octodec, Spear, Stor-Age and Vukile. That is a meaningful position for an asset class that many multi-asset investors quietly abandoned over the past eight years.

We understand why. Listed property gave investors two painful lessons in quick succession, first with the collapse of the Resilient group of companies in 2018 and then with the COVID-19 pandemic in 2020. Both damaged the sector's reputation as a dependable source of growing income.

Yet the sector that has emerged from those years is very different from the one that went into them. It is less geared, more conservative in how much of its earnings it pays out, and growing its dividends well ahead of inflation. In this article we explain the role we think real estate plays in a diversified portfolio, why SA REITs are particularly well suited to retirement savings, what went wrong, what has changed, and how we have built the property allocation in the Merchant West SCI Balanced Plus Fund.

What real estate brings to a multi-asset portfolio

Real estate earns its place in a portfolio for three reasons: a high and growing cash income, a degree of inflation protection, and returns that do not move in lockstep with either equities or bonds.

Income that grows. A REIT is essentially a pool of leases. Tenants pay rent monthly, most leases carry annual escalations of 6% to 8%, and REITs are required to distribute at least 75% of their distributable profits to shareholders. The result is an asset that behaves partly like a bond, with a contractual income stream, and partly like an equity, because that income can grow over time. At the end of September, the sector offered a forward dividend yield of 7.0%, and rolling 12-month distribution growth stood at 11.1%, more than six percentage points ahead of inflation of 4.4%.

Inflation protection. Bonds pay a fixed coupon that inflation erodes. Rental escalations, turnover-based rentals and the replacement cost of buildings all tend to rise with the general price level, so property income has historically kept pace with, or beaten, inflation over full cycles.

Diversification. Listed property is often treated as a geared bet on interest rates, but 2026 has shown that it is more than that. In July the sector returned 1.4% while the All Bond Index fell 1.4%. In September it returned 1.6% while the All Share Index fell 5.8%. Year-to-date to end-September, SA REITs returned 4.0%, ahead of bonds at 3.5% and equities at -3.2%. A third return stream that zigs when the others zag is exactly what a multi-asset fund needs.

A natural fit for retirement savings

We have long believed that SA REITs are at their most valuable inside compulsory savings vehicles: retirement funds, retirement annuities and preservation funds, and in particular living annuities.

The reason starts with tax. A REIT pays no tax on the income it distributes; instead, the distribution is taxed in the hands of the investor as ordinary income rather than as a dividend. For an individual investing in their own name, that can mean tax at a marginal rate of up to 45%, which makes REITs a relatively expensive way to earn income outside a tax wrapper. Inside a retirement fund or living annuity

the picture is reversed. Those vehicles pay no tax on income or capital gains, so the full distribution is retained and compounded.

For living annuitants there is a second, equally important benefit: predictability. A pensioner drawing an income needs cash, and selling growth assets in a falling market to fund that draw locks in losses. A portfolio that generates a 7% cash yield, growing ahead of inflation, funds much of that draw from income rather than capital. That is why, in more normal times, we described listed property as a cornerstone of a retirement income plan.

Where the shine went

Until 2017, listed property had been the best-performing local asset class for the better part of fifteen years. Two shocks ended that run.

Resilient, 2018. In early 2018, allegations of share-price manipulation hit the Resilient group of companies: Resilient, Fortress, Nepi Rockcastle and Greenbay. Those four counters had grown to more than 40% of the SA Listed Property Index, largely by issuing shares at large premiums to their net asset value. Within five months Resilient had lost 56% and Fortress B 63%. The SA Listed Property Index returned -25.3% for 2018, its worst calendar year since inception in 1993, and only 1.9% in 2019. The lesson was about concentration and governance: a sector index dominated by one stable of interlinked companies was far riskier than it looked.

COVID-19, 2020. The pandemic then struck at the heart of the income case. Lockdowns closed shopping centres and offices, landlords granted rent relief and deferrals, and most REITs cut their payout ratios from the traditional 100% to between 75% and 85% to preserve cash. The Index fell almost 50% at its worst and ended 2020 down 34.5%. In the Nedgroup Investments Property Fund, which we manage, distributions more than halved that year. For living annuitants who had relied on property for predictable income, this was the real damage: not just a capital loss, but the loss of the very cash flow they had bought the asset for.

A different sector today

The sector has used the past five years to repair itself, and the returns since mid-2024 reflect that: SA REITs returned 35.8% in 2024 and 38.6% in 2025. More important than the re-rating is what sits underneath it.

Stronger balance sheets. Gearing has come down across the sector through disposals and equity raises. Growthpoint's SA loan-to-value ratio is now 30.2%, Fairvest expects to be below 27% and Spear sits at about 23%, among the most conservative in the sector. In 2026 alone, Spear, Fairvest, Vukile, Hyprop and Fortress all raised equity, much of it oversubscribed and placed at or above the market price.

More conservative payouts. Most REITs never returned to paying out 100% of earnings. Retaining part of their income gives them a buffer to absorb higher interest costs or a weaker trading period without cutting the dividend, and funds capital expenditure without new debt.

Real income growth. Rolling distribution growth has outpaced inflation for six consecutive quarters, reaching 11.09% in September, the strongest reading since 2017 outside the post-COVID recovery.

A broader, less concentrated market. No single group dominates the Index as the Resilient stable once did. In March 2026, Dipula, Octodec and Spear were added to the FTSE/JSE All Property Index and SA REIT Index, deepening the investable universe beyond the traditional large caps.

How we have built the property allocation in the Merchant West SCI Balanced Plus Fund

The lessons of 2018 and 2020 shape how we invest. We favour South African-focused landlords with low gearing, defensive and growing income, and management teams that allocate capital well. We avoid paying for growth funded by issuing expensive shares, and we are selective about offshore exposure now that global long-bond yields are at multi-decade highs, preferring operators like Vukile whose Iberian assets are 99% let and re-leasing above previous rentals.

Growthpoint is the exception that proves the rule. Its growth outlook is the weakest of the seven, but as the sector heavyweight it anchors the allocation to the broader market and limits the factor risk of running a concentrated, mid-cap-tilted portfolio.

Holding	What it owns	Why we hold it
Dipula	Convenience and community retail, increasingly so after its R2.04bn acquisition of nine Moolman shopping centres	Retail rises to about 80% of income; 7%–8% distribution growth guided
Fairvest	Retail centres serving lower-income consumers, plus township fibre through Onepath	Guiding to the top of 11%–13% growth; positive reversions; LTV below 27%
Growthpoint	The sector's largest diversified landlord	Benchmark anchor; SA LTV down to 30.2% after R4.9bn of disposals
Octodec	Residential, retail and commercial property in the Tshwane and Johannesburg CBDs	Interim distributable income up 11.1%; trades well below NAV; Emira now a 23.9% shareholder
Spear	Western Cape industrial, retail and office property	One of the lowest-geared REITs (LTV about 23%); growing exposure to the country's strongest regional economy
Stor-Age	Self-storage in South Africa and the UK	Specialist, defensive income; expanding locally through the Xtraspace and Execustore acquisitions
Vukile	SA township and rural retail, and Castellana's Iberian retail	SA vacancy of 1.9%; one of the few guiding to 10%–12% dividend growth for FY2027

At 6% of the fund, the allocation is large enough to contribute meaningfully to income and diversification, but small enough that a sector-wide setback does not dominate the Fund's returns.

The risks, and our conclusion

We are not complacent. The interest-rate cycle has turned: the Reserve Bank raised the repo rate to 7.25% in September and the US Federal Reserve hiked for the first time since 2023. Companies that reported in September point to mid-to-high single-digit distribution growth in FY2027, below the 11% just delivered. The sector's forward yield of 7.03% now sits 188 basis points below the long bond, against a long-run average of about 14 basis points, so valuations depend on that growth holding up. Previous peaks in distribution growth, in 2008 and 2016, were followed by tightening cycles that tested it.

That is precisely why balance-sheet quality matters more than sector exposure. Lower gearing and retained earnings mean today's REITs can absorb higher funding costs far better than they could in 2018 or 2020, and our holdings are among the better-capitalised in the market.

Real estate remains what it has always been at its best: a source of growing cash income, a partial hedge against inflation, and a diversifier for both equities and bonds, with tax advantages that make it especially valuable inside retirement savings. The sector lost its shine for good reasons. We think it has earned some of it back, and a selective 6% allocation lets Merchant West SCI Balanced Plus Fund investors share in that income while keeping the lessons of the past firmly in mind.

Thin margins, thick cash: Why we like McKesson



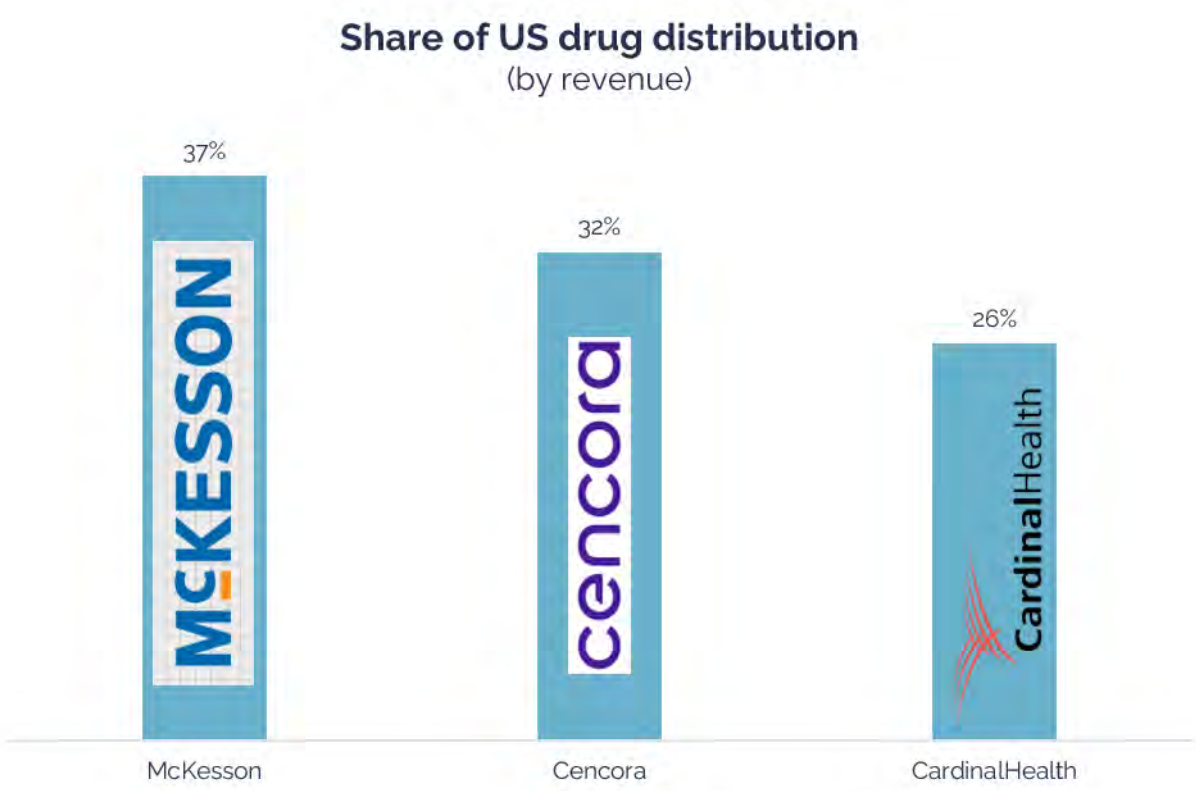
Bianca Lakha

Investors tend to be drawn to the fastest-growing companies in the market, and it is easy to overlook businesses whose main appeal is that they keep growing, year after year, without much drama. McKesson is one of those businesses. It sits between the companies that make medicines and the pharmacies, hospitals and clinics that dispense them. Roughly a third of all prescription medicines in the United States pass through its warehouses.

At first glance the numbers can look unappealing, because McKesson keeps only about 1.6 cents of operating profit for every dollar of medicine it sells. But look past the margin, and the record looks quite different: revenue has grown in every one of the last ten years, and adjusted earnings per share have roughly tripled. We think that consistency is worth far more than the margin suggests, and the reason lies in how the business makes its money.

The middleman nobody sees

McKesson is the largest of the three wholesalers that dominate US drug distribution, alongside Cardinal Health and Cencora. It buys from around 1 300 manufacturers and delivers to roughly 180 000 pharmacies, hospitals and clinics, with US pharmacy chain CVS alone accounting for about a quarter of revenue. The demand behind this is about as dependable as demand gets, since people tend not to stop taking blood pressure tablets or insulin because the economy slows or interest rates rise.



Growth without the drama

That steady base has translated into an unusually consistent growth record. Revenue has grown in every one of the past ten years, through good economic conditions and bad, and over that period earnings per share have grown considerably faster than sales. Earnings per share dipped only once, early in the decade when falling generic drug prices weighed on profits, and have risen every year since.



Source: Bloomberg

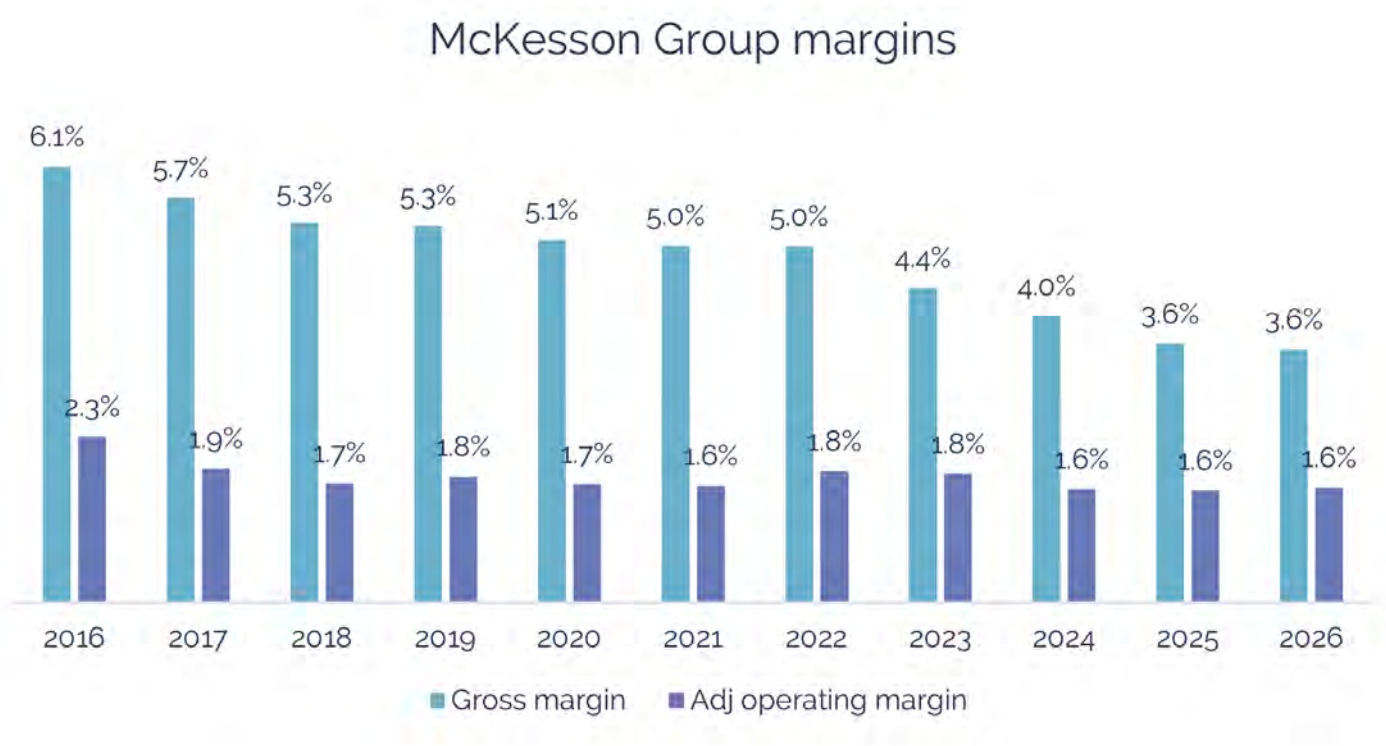
What we find most attractive is that this growth does not rely on a single product, trend or point in the economic cycle. It comes from steady prescription volumes, a gradual shift towards higher-margin services and the steady return of cash to shareholders. Growth like this can seem less exciting than a fast-moving technology story, but it tends to be more predictable, and predictability matters a great deal when returns compound over long periods.

Revenue is not the same as profit

McKesson earns money in two quite different ways. Branded drugs, the patented medicines that make up most of its revenue, are the first. McKesson buys each drug from the manufacturer and sells it to the pharmacy for close to the price it paid, so the full price of the medicine shows up in its revenue, even though very little of that money stays with McKesson. What it keeps is a fee the manufacturer pays for handling the product, and that fee is now a largely fixed, negotiated amount rather than a percentage of the drug's price. If a drug that costs $1 000 goes up to $1 100, for example, McKesson's revenue rises by $100, but the fee it keeps stays much the same. The boom in GLP-1 weight-loss drugs is a good illustration, having lifted sales considerably without doing much for profits, and we think this explains much of why the gross margin has drifted from about 6% to under 4% over the decade.

Generic drugs work the other way round. Once a patent expires, many manufacturers make the same pill and compete for a place on McKesson's shelves, which shifts the negotiating power to McKesson and allows it to buy well below the list price and sell to pharmacies at a healthy spread. Generics make up only about 10% of revenue but roughly 60% of profit. To protect that spread, McKesson pools its generic purchasing with Walmart through a joint venture called ClarusONE.

Together with the fixed fees on branded drugs and tight cost control, this helps explain why the operating margin has barely moved while the gross margin has fallen over the past decade, holding at a little under 2% in every year since 2017.



Source: Bloomberg

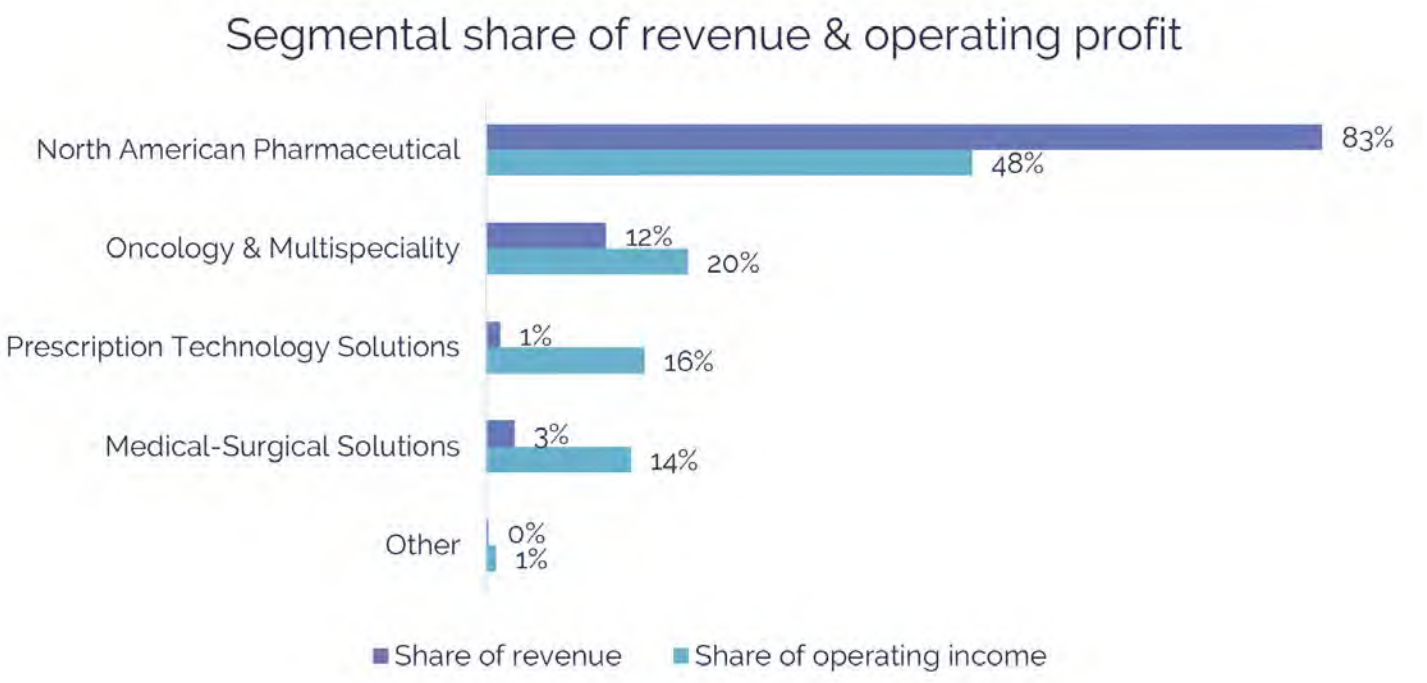
Getting paid before paying

One of the less visible strengths of the business is how it manages cash. Most companies pay for their stock before they sell it, so growing sales usually means tying up more money. McKesson's position is closer to the reverse. It collects from customers (the pharmacies and hospitals) within about 25 days but takes around 56 days to pay its suppliers (the drug manufacturers), so the medicine has usually been sold and paid for well before McKesson settles its own bill.

A simple way to picture it is a shop whose supplier gives it two months to pay while its customers pay within a few weeks. As the shop grows, the amount it owes its supplier grows too, and that unpaid balance effectively helps fund the business. Suppliers now fund around $7.8bn of McKesson's day-to-day operations, whereas ten years ago it had about $4.7bn of its own money tied up. This is a large part of why the company generates more cash than its profits suggest. Over the past decade the free cash flow McKesson has produced, meaning the cash left over after reinvesting in the business, has been roughly double the profits it reported.

A higher-margin layer on top

Distribution is likely to remain a thin-margin activity, so part of the story is what McKesson builds on top of it, particularly in cancer care. Cancer drugs are usually given in clinics, which means a small oncology practice has to buy, store and bill insurers for drugs that can cost thousands of dollars a dose. McKesson provides the purchasing power, billing support and software these practices would struggle to build themselves.



Source: Bloomberg

These smaller businesses now generate about half of McKesson's operating profit from less than a fifth of its revenue. Much of this platform was acquired rather than built, so we will be watching to see that it keeps growing on its own.

Fewer shares, bigger slices

Because the business needs relatively little capital to run, much of that cash has gone back to shareholders through share buybacks, which have retired nearly half the shares in issue over the past decade. Each year's profit is therefore shared among far fewer shares, and this has done much of the work in lifting earnings per share well above the underlying growth of the business.

What could go wrong

Drug pricing remains a political issue in the US, and slower price increases on branded medicines could weigh on sales and part of the profit pool. Regulators have also been tightening the rules on drugs administered in clinics, which affects the oncology business directly. McKesson relies heavily on a few large customers, is still paying out opioid litigation settlements, and has limited room for error with margins this thin. Buybacks have also done much of the work in earnings growth, and that lever only works while the cash keeps coming.

Why consistency matters

Our case for McKesson rests on the reliability of its demand, the consistency of its growth and the quality of its cash flow, more than on a dominant competitive position.

Over time, we think returns from a business like McKesson tend to come mainly from steady growth in earnings per share rather than from the market paying more for each dollar of earnings, which is why the consistency of that growth matters so much to us. McKesson may rarely be the most talked-about company in a portfolio, but a business that has grown this consistently through a pandemic and several turns in the economic cycle is one we are happy to own for the long term.

CME Group: The toll road on risk



Joshua Viljoen

From Dojima to Chicago

The idea of locking in a price today for delivery tomorrow is thousands of years old, but the futures market as we know it started in 18th-century Japan. In Osaka, feudal lords were paid taxes in rice and shipped it to the Dojima rice market to sell for cash. Warehouse receipts for stored rice began to trade as paper claims, and by the early 1700s merchants were dealing in contracts for rice at fixed future dates, almost always settled by paying the price difference rather than moving the grain, akin to modern-day cash-settled (rather than physically settled) contracts.

The shogunate (the military government that ruled Japan for most of the period from 1185 to 1868) formally recognised the market in 1730. Historians widely regard Dojima as the first organised futures market, with standard terms, set settlement dates and offsetting cash settlement.

What rice was to Osaka, grain was to Chicago, and in 1848 the Chicago Board of Trade was founded to bring order to the Midwest harvest trade. Its cross-town rival, the Chicago Mercantile Exchange, later took the idea further by listing futures on currencies and interest rates, and the two merged in 2007 to form CME Group.



Rice Market at Dojima, 1834

The World's Risk Marketplace

CME Group operates the world's dominant listed-derivatives franchise, used for both hedging and speculation. The company operates four designated contract markets in the United States: Chicago Mercantile Exchange (CME), Chicago Board of Trade (CBOT), New York Mercantile Exchange (NYMEX) and Commodity Exchange Inc (COMEX). The core futures products traded on CME's exchanges include US Treasury and SOFR interest rate futures, WTI Crude Oil futures, equity index futures, precious metals and agricultural commodities such as corn and soybeans.

A Toll Road on Risk

The customer base is overwhelmingly institutional, including banks and dealers, asset managers, hedge funds, proprietary trading firms and commercial hedgers like farmers and oil producers. The beauty of a futures exchange is that it is a toll road on risk. CME is indifferent as to whether markets are moving upwards or downwards and simply collects trading and clearing fees regardless of whether a customer is going long oil or short US interest rate futures. Many challengers have tried to encroach on CME's toll-road-like monopoly in key futures products and have failed.

The reason for this comes down to understanding the network effects and market structure of a futures market. Within an exchange, liquidity begets liquidity, and traders go where other traders are. Whilst a rival exchange could try to offer a US interest rate future at a lower fee per contract than CME, this will not ultimately cause traders to switch volumes, as a lower fee per contract will still result in higher all-in trading costs if a challenger cannot match CME's liquidity and bid-ask spread tightness. This is why CME has held a de facto monopoly in US rates futures for over 40 years.

Owning the Clearing House

The second structural advantage a futures exchange has over an equity exchange is the clearing house structure. In US equity markets there is typically no vertical integration, and the exchange operator, clearing house and custodian are typically three separate parties. In a futures market, however, the exchange operator tends to own and operate its own clearing house. CME Clearing is one of the largest clearing houses in the world, and whenever someone trades a futures contract on CME, it collects not only the trading fee but the clearing fee too.

Antifragile by Design

The core idea of Nassim Nicholas Taleb's 2012 book Antifragile is that fragile things are harmed by volatility, shocks and stress. Robust things resist them and stay the same, whilst antifragile things get better from them. His examples are a coffee cup (fragile), a rock (robust) and the mythical Hydra, which grows two heads for each one cut off (antifragile).



Hercules fighting the multi-headed Lernaean Hydra

We view CME as an excellent example of an antifragile business given how it performs under periods of market stress and volatility. This is evident in how the business performed during the Middle East conflict. In the first quarter of 2026, CME's energy average daily volume grew 37% year on year to a record four million contracts, with WTI Crude Oil futures growing 70% year on year. The company's fundamentals and share price responded positively to a period of market stress: over Q1 2026 CME's shares gained 10.7% whilst the S&P 500 declined by 4.6%, an outperformance of more than 15 percentage points over the quarter. Like the Hydra, every shock to the market seems to leave CME with more heads, not fewer.

A Diversifier in the Portfolio

As legendary hedge fund manager Ray Dalio notes, the Holy Grail of investing is to find 15 to 20 good, uncorrelated return streams. CME fits this narrative nicely and exhibits extremely low correlation to the broader equity market with a daily correlation to the S&P 500 of less than 0.18 over the last five years.

Nearly three centuries after Osaka's rice merchants first traded promises on future harvests, the underlying need has not changed: producers, consumers and investors still need a trusted venue in which to transfer risk. CME has built the deepest pool of liquidity in which to do so, owns the clearing house that stands behind every trade, and earns a fee on every contract bought or sold, regardless of market direction.

In a world where volatility increasingly appears to be the norm rather than the exception, we believe owning the toll road on risk offers both high-quality compounding and genuine diversification. This is why CME is held across our global equity portfolios: when shocks hit and much of the portfolio comes under pressure, CME is one of the holdings designed to get stronger.

MTU Aero Engines: Long-duration economics, on sale



Neal Hoogwerf

The Airline industry isn't the first place a quality-focused investment house usually looks for idiosyncratic opportunities. The industry is known for earning returns below their cost of capital, being exposed to macro-economic shocks and the cyclicality of commodity inputs.

Through our bottom-up research process, we've been able to find opportunities within the maintenance and spare parts side of the industry. MTU Aero Engines provides a unique example about how we think about global businesses that aren't exposed to AI risk and can compound capital for decades ahead.

A business most people use without knowing it

When you board an Airbus A320neo, one of the most common passenger aircraft in the world, there is a good chance that part of the engine was designed and built by MTU. More than 30% of the world's commercial aircraft carry MTU technology on board. Yet few travellers have heard of the company, because it sits one step behind the household names.

MTU's history goes back to 1934, when it began life as BMW's aircraft engine division. For much of the twentieth century its focus was military, and it remains a key partner to the German Armed Forces, contributing to the engines of the Eurofighter Typhoon and the Airbus A400M transport aircraft. Since listing in 2005, however, the business has shifted decisively towards commercial aviation, which now dominates its earnings.

Today MTU makes money in two connected ways.

The first is as a partner on engine programmes. Building a modern jet engine costs billions and takes many years, so the large engine makers (Pratt & Whitney, GE Aerospace and others) share the burden with specialist partners. MTU co-funds the development of specific engine sections, such as the low-pressure turbine and parts of the compressor, and takes full responsibility for designing and producing them. In return it receives a fixed share of that engine's revenue for as long as the engine family exists. There is no expiry date, no renegotiation and no renewal risk. In practice these partnerships run 40 to 50 years: roughly a decade or more of development, around 25 years in production, and a long tail of servicing after that. To illustrate how durable these relationships are, MTU has been a partner on GE's CF6 engine, which powers aircraft such as the Boeing 767, since 1971.

The most important of these programmes is Pratt & Whitney's Geared Turbofan, or GTF, which powers the Airbus A320neo family and the Airbus A220. MTU holds an 18% share of the programme. The GTF now powers over 2 600 aircraft with an installed base of roughly 5 000 engines, and more than 13 000 additional engines are on order.

The second way MTU makes money is through **maintenance, repair and overhaul (MRO).** Jet engines are serviced regularly throughout their working lives, and those services are expensive. MTU is the largest independent engine maintenance provider in the world. In 2025 its network of more than 7 000 engine specialists across five continents processed around 1 500 engines for more than 270 airline customers. MRO has grown rapidly, from about 40% of revenue in 2016 to roughly two-thirds today.

Why the model is so attractive

The key to understanding MTU is a simple idea that will be familiar from razors and printers: the initial sale is not where the money is made. New engines are often sold to airlines at thin margins or even at a loss. The real economics lie in the decades of spare parts and servicing that follow, which are both predictable and profitable.

This shows clearly in MTU's numbers. Although the engine partnership business (which includes spare parts sales) accounts for only about a third of revenue, it generates roughly 65% of operating profit, with margins of around 30%. The maintenance business earns lower margins, around 8 to 9%, but it is larger, growing quickly, and ties MTU into airlines' operations for the long term.

Timing matters too. The GTF installed base is on average just four years old. Engines typically need their first major overhaul after five to seven years of service, which means the bulk of the profitable aftermarket income on this engine still lies ahead. Even if Pratt & Whitney never sold another GTF, the engines already delivered or on order would keep generating servicing revenue for MTU for another 30 to 40 years.

The maintenance contracts themselves add to this visibility. Roughly 80 to 90% of the GTF fleet is covered by long-term service agreements, usually lasting 10 to 15 years. Most work like a subscription: the airline pays a fixed rate for every hour the engine flies, and MTU takes on responsibility for keeping it maintained. MTU's order book reached about €29.5bn at the end of 2025, equivalent to around 3.4 years of revenue, and its maintenance capacity is currently fully booked. If one customer delays a shop visit, another from the queue fills the slot.

Barriers to entry

Several features make MTU's position difficult to replicate. Aviation is heavily regulated, and producing safety-critical engine parts requires both regulatory approval and access to technical design data, which few companies obtain. Engine generations take 20 years or more to develop and then stay in service for decades, so a competitor cannot displace MTU's share of a programme without redesigning and recertifying the whole engine. MTU also benefits from scale: as the largest independent maintenance provider, it sees more engines, accumulates more data and spreads its costs more widely than smaller rivals.

Most importantly, MTU combines two roles that are normally separate. Pure maintenance providers such as StandardAero service engines, but did not design them. Component specialists such as GKN Aerospace build parts but do not service them at scale. MTU does both, which gives it detailed knowledge of how engines wear and fail that competitors outside the original design partnership cannot easily access.
The industry backdrop

The long-term demand picture for aviation remains favourable. Global air travel has historically grown at roughly twice the rate of global economic growth, driven by rising middle-class incomes, the spread of low-cost airlines and greater international mobility. Industry forecasts point to around 4% annual growth in passenger traffic over the next 20 years and some 46 000 new jet aircraft deliveries, of which around 32 600 are single-aisle planes, the segment where the GTF competes.

At the same time, aircraft manufacturers have struggled to keep up. Production delays and supply chain problems have left the industry roughly 5 000 aircraft short of pre-pandemic delivery expectations since 2018. Airlines have responded by keeping older planes flying for longer. For engine makers and maintenance providers, this combination of strong demand and constrained supply means more flight hours, more spare parts consumption and more servicing work.

Assessing Quality through the Cycle

Looking through the cycle, MTU has consistently earned attractive returns. Normalised return on invested capital has averaged around 18% since 2007, comfortably above its cost of capital. The dips in that history line up with identifiable events: an investment phase in the 2010s when MTU funded its stake in the GTF and GEnx programmes, COVID, and the 2023 GTF charge. Each time, returns recovered. Return on equity reached 26% in 2025, the highest in over a decade.

The growth record is strong. Over the past five years, revenue has compounded at around 17% a year and operating profit at around 30%. Over the past decade, adjusted earnings per share have grown at roughly 16% a year.

Management has a strong record of under-promising and over-delivering. MTU has beaten its initial operating profit guidance in 10 of the last 11 years, with COVID the only exception. In 2025, it guided to operating cash earnings of about €1.2bn and delivered €1.35bn. The leadership team has been refreshed recently, with Dr Johannes Bussmann appointed CEO in September 2025. He brings over 20 years of industry experience, including seven as CEO of Lufthansa Technik, one of the world's largest aviation maintenance businesses, which is directly relevant to MTU's growing MRO division.

MTU also scores well on sustainability measures, rated as leading its peer group by Bloomberg and holding an A rating from MSCI. This matters in aviation, where pressure to cut emissions will shape the next generation of engines. MTU is investing in that future through the next-generation GTF and its hydrogen-powered “Flying Fuel Cell” research programme.

Looking ahead

The next milestone is MTU’s Capital Markets Day in November, where we expect management to update its medium-term targets. Given its record of raising guidance, we think the event could help the market focus on the underlying earnings power of the business. MTU fundamentally is a high-quality aero-engine franchise with embedded positions on critical programmes, decades of aftermarket cash flow ahead of it, growth driven by flight hours rather than the economic cycle, and a management team with a history of beating expectations.

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Glossary

- Annualised Returns - Annualised return is the weighted average compound growth rate over the period measured.
- Asset Allocation - Refers to the mixture of investments and each investment value in an investor's portfolio.
- Asset Class - An investment instrument or category. Asset class types include cash, equity, listed property, and bonds.
- Bonds - A type of financial investment that involves lending money to an institution for a fixed period of time.
- Commodities - Raw materials (wheat, oil, gold) used to create consumer products. Investors monitor these products to predict price changes.
- Cumulative Returns - Cumulative return is the aggregate return of the portfolio for a specified period.
- Diversification - Diversification is a technique that reduces risk by allocating investments among various financial instruments,
- industries, and other categories. It aims to maximize return by investing in different areas that should each react differently to changes in market conditions.
- Dividends - Dividends are how a company rewards or pays out a portion of its profits to shareholders/ investors.
- Equities - Equity is money that is invested in a company by purchasing shares of that company in the stock market. These shares are typically traded on a stock exchange.
- Fund Class - Each class invests in the same portfolio of securities and has the same investment objectives and policies. But each class has different shareholder services and/or distribution arrangements with different fees and expenses.
- GMGF - Merchant West SCI Global Managed Growth Fund
- Inflation - Inflation is the weakening of a currency's purchasing power over a period of time. The rise in prices for goods and services means that a unit of currency effectively purchases less than it did in prior periods with the same value of currency.
- Liquidity - Liquidity refers to the ease with which an asset can be converted into cash without affecting its market price. The most liquid asset of all is cash itself.
- Quality Investing - Quality investing is an investment strategy based on a set of clearly defined Fundamental criteria that seek to identify companies with positive quality characteristics. The quality assessment is made based on soft and hard criteria.
- Quality Investing Criteria - Companies with attractive earnings and dividend growth prospects.
- Shares - Shares are the units of the ownership of a company, usually traded on the stock market. They are also known as stocks, or equities.
- Stocks - A stock (also known as an equity) is a security that represents the ownership of a fraction of a corporation. This entitles the owner of the stock to a proportion of the corporation's assets and profits equal to how much stock they own. Units of stock are called "shares."
- Yield - Yield refers to the earnings gained on an investment over a specific period of time.

Merchant West SCI Balanced Plus Fund A1				
Annualised Performance	Fund %	Benchmark %	Annual Returns	%
1 year	4.5	6.3	Highest Annual %	17.4
3 years	12.3	13.3	Lowest Annual %	-1.8
5 years	10.4	10.5		
10 years	7.4	8.3		
Since inception (March 2012)	7.9	8.9		

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