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ISSUE 19: DECEMBER 2017

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FROM THE EDITOR

Welcome to the final edition of *Best of the Best* for 2017. Investors should be in a quandary. On one hand, economic conditions border on the Goldilocks, which of course is good news for investors. A Goldilocks economy is an economy that is not too hot or cold, in other words sustains moderate economic growth, and that has low inflation, which allows a market-friendly monetary policy. Additionally, volatility has reached historic lows, and unsurprisingly equity markets from Germany to South Africa have been strong, credit spreads have narrowed, investment grade corporate bond yields are within 1 per cent of treasuries and spreads in emerging market bonds are as narrow as they were just before the global financial crisis. In Australia, conditions are similar.

But caution is wise.

Firstly, it is worth remembering there is no correlation between equity market returns and economic conditions. When economic conditions are stronger than average, there is a 50 per cent chance the stock market will perform better than average. Although there is a 50 per cent chance the stock market will perform worse than average.

More importantly, at Montgomery, we cannot find broad value (although 'Quality' is better value than 'cyclicals'). In the US and globally, markets have run way ahead of earnings per share growth. As an example, there are 28 stocks in the S&P 500 trading at more that ten times revenue. To put the situation in perspective, there were 29 companies at more than ten times revenue at the peak before the tech wreck.

In another sign of irrational exuberance, there are more than a dozen companies on the NASDAQ100 trading on P/E ratios of over 250 times.

Indeed, it seems companies losing more than $1 billion per year are amongst the stocks gaining the most.

It's a confusing backdrop for investors. Unemployment is nearing 'full employment,' inflation remains low, and a growing chorus of fund managers are bullish on markets and economies. But the implied equity risk premium (ERP) for the S&P 500 has dropped from a peak of 8 per cent in 2012 to its current level of 3 per cent, its lowest level in a decade. This is important because it suggests buying at current prices is tantamount to locking in very low rates of return.

Across all of our funds, cash is one of the highest weightings and possibly getting higher. It is without coincidence that we have structured our funds with the flexibility to hold high percentages of cash or to be able to short stocks and profit from declining markets and prices.

If you are investing today, it is time to look forward rather than backwards and consider the benefits of funds that can protect capital through cash or the ability to short sell.

Thank you for your support in 2017. We take managing your capital with great responsibility.

I wish you and your family a safe and peaceful Christmas and new year.

Sincerely yours,

Roger Montgomery

Chief Investment Officer

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Why it's time to invest in quality businesses

Tim Kelley, Head of Research

For the past 18 months, Australian investors have seen a 'junk rally' in which lower quality businesses have outperformed, writes Tim.

For the past 18 months, Australian investors have seen a 'junk rally' in which lower quality businesses have outperformed. But our research shows that quality is now better value than it has been for many years.

Investment managers who focus on business quality have found this to be a very difficult period, with cyclical and resources businesses enjoying very strong share price gains, while businesses generally viewed to be higher-quality have tended to languish. Being a quality-obsessed manager ourselves, we felt this acutely in 2016, when our portfolio essentially tracked sideways while the market stretched to reach new heights.

However, it is also the case that 2015 was an exceptional year for us. Our portfolio soared, while the market essentially went nowhere.

Clients who understand our philosophy and approach have generally accepted that the 2016 result was driven more by things we don't (and won't) own than by anything else, but some advisers recently asked us a very insightful question: they wanted to know whether the recent underperformance of high quality businesses meant that high quality was now good value, or if 2016 was simply an unwinding of overvaluation that had arisen at the end of 2015.

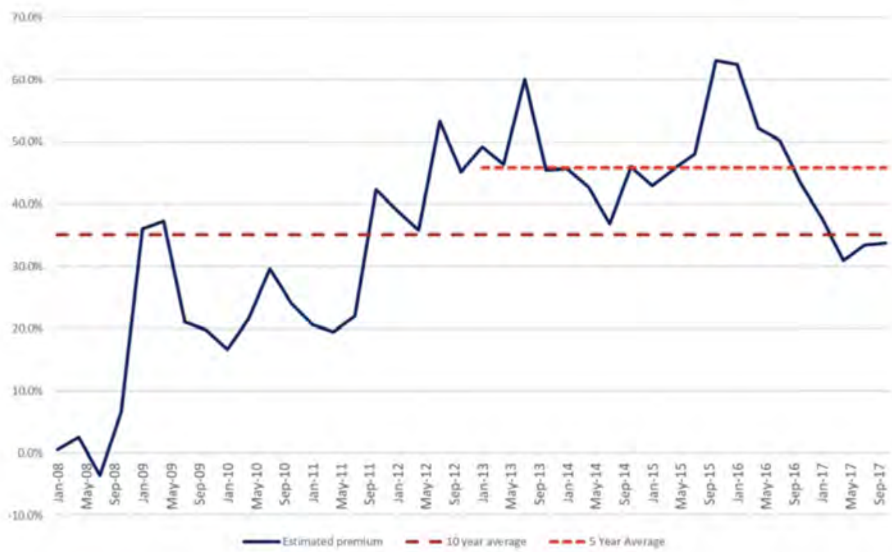
We put together some analysis to explore this question, and the results contain some very worthwhile insights.

What we did was to construct two equal-weighted portfolios, one containing what we consider to be the highest quality companies on the ASX, and one containing the lowest, in each case subject to a minimum size requirement, and a requirement that each company have been listed for at least ten years.

OUR RESEARCH SHOWS THAT QUALITY IS NOW BETTER VALUE THAN IT HAS BEEN FOR MANY YEARS.

We then compared the median book to market ratio for each portfolio over a ten-year period. We did this because our view of a high-quality business is one that creates a large amount of shareholder value for each dollar of shareholder capital invested. By definition, these businesses should trade at a premium book to market ratio, and by measuring that premium, we can construct a gauge of the price of quality.

The results of this analysis are set out on the next page.



Source: MIM

There are quite a few things that may be taken away from this chart, so let's walk through them chronologically.

Firstly, we were intrigued to see the quality premium at zero at the start of our ten-year time frame. However, on reflection, this makes sense. In 2008, the resources boom was reaching its peak, with iron ore prices at around $180/tonne, and a prevailing view that Chinese-led growth would be "stronger for longer." Resources companies are strongly represented in our low-quality portfolio, and in 2008, prices for many of these were reaching very high levels.

The arrival of the GFC drove a sharp correction to the quality premium, in what might be considered a "flight to quality." However, the resources boom was not quite finished at this point. The iron ore price again reached $180 in 2011 and, during that period, the quality premium remained at what looks to be a relatively low level.

When we calculate a ten-year average for the quality premium, we find that it lines up with the current level. However, this average is significantly influenced by the resources boom period, and whether this average is indicative of the potential future level depends on whether you think the resources boom was an unusual event. Looking at share price charts that cover this period, we are inclined to view it as unusual.

Moving forward in time, we see that 2015 was indeed a good time to be invested in quality, as the premium rose to its highest level of the past decade. We need to acknowledge here that the very strong relative performance numbers we recorded in 2015 owe a significant debt to the quality tailwinds experienced during that period.

During 2016, however, we see what looks to be the largest drawdown of the quality premium for the past decade, bringing it to the lowest level seen for more than 5 years. During this period, markets have become increasingly buoyant, and increasingly willing to ignore stretched valuations and growing risks. It's a market environment that bears more than a passing resemblance to the environment that prevailed ahead of the GFC.

So where does that leave us in terms of future prospects?

There are several observations that we would make:

Firstly, academic research indicates that high quality tends to outperform low quality over long stretches of time, notwithstanding that there will be periods of sharp underperformance. This is consistent with the experience of The Montgomery Fund, which has shown higher returns and lower risk than the market in the five years since its inception, notwithstanding a period of sharp underperformance recently.

Today, high quality looks to be somewhere between cheap and fair value based on historical averages, depending on how you think about the resources boom. Accordingly, it seems reasonable to expect high-quality to deliver superior long-run returns from here.

The analysis hints at quality tending to outperform when market conditions are difficult, and underperforming when conditions are buoyant, and this view is also supported by academic research. In a world where asset prices generally appear stretched, this may be an important point.

So, for several reasons, it seems like it makes sense for investors to focus on owning higher-quality businesses today. However, it is also the case that there is scope for the quality premium to fall further in the near term. A continued strong run for equity markets generally, and for cyclical and resources businesses in particular, could drive this outcome.

If that should happen, we suspect that many investors will be tempted to join the bandwagon and chase the apparently high returns offered by these types of business. Human nature being what it is, investors tend to buy an investment strategy after it has done well, and sell it after it has done poorly.

More often than not, a better approach is to do the exact opposite.

This article was written on 19 October 2017. All share and other prices and movements in prices are on this date.

Why 'time in the market' will make you wealthier

Christopher Demasi, Portfolio Manager

Christopher Demasi ends the debate on whether you do better by 'time in the market' or 'timing the market'.

It's time to end the debate on whether you do better by 'time in the market' or 'timing the market'. According to research by Fidelity Investments, 'time in the market' wins, hands down.

Whether you are a student of finance or just in tune with your own gut feelings, it should come as no surprise that investors typically try to time their entry into, and exit from, the market in order to juice returns and sidestep risks. Similarly, investors usually try to time their investments in managed funds. But the best way for an investor to improve performance is to remain invested in a sound strategy with a trusted manager for the long term.

Let's take a look at two interesting and instructive stories from the world of investing.

Time in the market

A few years ago Fidelity Investments, one of the world's largest fund managers with over US$2 trillion in client assets, concluded an internal study to determine which type of clients tend to achieve the best investment returns. The results were both surprising (to most) and meaningful (to all).

The study reviewed client accounts from 2003 through to 2013 and found that the best performing accounts were from investors that were dead! In second place were investors that had ***forgotten they had accounts at Fidelity!*** Of course, both groups of investors have one key characteristic in common: they didn't try to time the market, in or out.

Time in the fund

On a Fidelity-related note, a lot of readers will have heard of legendary investor Peter Lynch. Lynch was the manager of the Magellan Fund at Fidelity between 1977 and 1990, during which time he beat the pants off the equity markets overall and beat it in most years. ***Lynch averaged a 29 per cent-plus annual return and his fund was the best performer in the world***. Yet Lynch calculated that the average investor in his fund didn't perform nearly as well.

By Lynch's numbers, ***the average investor in his fund made just 7 per cent***. Even worse, it was also reported that Fidelity's own analysis showed the average investor in Lynch's fund actually lost money! How so? Whenever Lynch would have a setback or underperform the market over short time periods, investors would redeem – or sell low. On the flip side of the coin, the times when Lynch was riding high and outperforming the market were the same times investors were allocating the most money to his fund – buying high and missing the upside from his relative lows.

When to invest

We are often asked the best time to invest in our two global equities strategies: the Montgomery Global Fund and Montaka. For investors looking to build wealth over years and minimise downside risk, the answer is now and for the long haul.

This article was written on 17 October 2017. All share and other prices and movements in prices are on this date.

Hold 'em or fold 'em? The 2 choices facing investors today

Roger Montgomery, Cheif Investment Officer

All assets seem to be held up by Goldilocks conditions, including accelerating economic growth, writes Roger.

Right now, investors are facing two options: invest in the market's momentum, while acknowledging that low returns are likely; or step aside, given the risk of low returns and higher volatility. Of late, we've chosen the latter option, as we are convinced it is the rational approach. But many investors seem to disagree.

Over the past six months, Montgomery funds have broadly matched the market's return despite very high levels of cash. But, over 18 months, we are a way off. The result is that investors are punishing managers, like us, who are acting rationally. To us, it's a sign that investors are willing to accept too much risk (more about such signs in a moment).

The economic backdrop is currently very supportive for equities. The conditions the Reserve Bank of Australia reported at the board's November meeting – accelerating economic growth at above trend rates, improving labour conditions, low wage and price inflation (3 per cent in the UK and 2.2 per cent in the US) and a de-risking of the household debt picture – are also being experienced in many developed economies. Unsurprisingly, equity markets from Germany to South Africa have been on a tear.

All assets seem to be held up by Goldilocks conditions, including accelerating economic growth – the US is now growing at an annualized rate of 3 per cent declining unemployment and an absence of wage inflation thanks to competitive forces, particularly in the retail sector.

> SHARE PRICES TODAY ARE BUOYED BY THE AFOREMENTIONED GOLDILOCKS CONDITIONS WHICH ARE EXPECTED TO TRANSLATE TO EVEN STRONGER EARNINGS GROWTH THAN IS BEING ACHIEVED CURRENTLY.

Notwithstanding double-digit falls in the resale prices of properties in a variety of inner Sydney suburbs, asset prices remain elevated and implied returns have reached historic lows.

The work we have done reverse engineering current share prices to arrive at the implied expectations embedded in them has revealed, in many cases, expectations that are simply impossible for companies to meet. By way of example, CSL's current share price can be justified only if double-digit earnings growth occurs, without interruption, for the next decade, and then continues to grow at rates above global economic growth rates, forever.

That would mean that CSL would eventually have to be rebranded 'Earth' because it would have taken over Google, Amazon, Apple, Facebook, Exxon Mobil and many other companies as it continues to expand at rates above the rest of the world. Similar expectations can be said to be supporting a variety of well-known large and mid-cap companies.

Share prices today are buoyed by the aforementioned Goldilocks conditions which are expected to translate to even stronger earnings growth than is being achieved currently. And currently US corporates are growing earnings at rates above expectations. But strong earnings growth has existed prior to previous market highs. Earnings were growing strongly prior to the global financial crisis, prior to the tech wreck and prior to the great crash of 1929, and share prices today have run even faster than the earnings growth rates currently being accomplished. There are now 28 companies in the S&P500 trading on a multiple of more than ten times revenue, and there are more than a dozen companies in the NASDAQ 100 trading at more than 240 times earnings. That's not a typo. Indeed, it seems that the most popular companies are those that are losing more than a billion dollars per year.

Tesla, Uber and Twitter make no money and collectively their market capitalization is over US$130 billion. The American Airlines CEO was recently quoted saying, "I don't think we'll ever lose money again."

In Australia, we aren't immune to the emerging exuberance either. Companies that are 'pre-revenue' are trading at nearly three quarters of a billion dollars. The listed property relocation start-up, Updater, generated revenue of just over US$500,000 in the six months to June 30 and its market cap can be counted in the many hundreds of millions.

Of course, high prices are not themselves a sign that the market is at imminent risk of a correction, but when the correction does occur, investors will look back on those high prices and wish they'd paid more attention to them. It's only on the other side that we see signs for what they are – shots over the bow.

Perhaps most importantly, it is worth noting that there is no correlation, in any year, between economic growth rates and stock market returns. Goldilocks conditions in the economy don't necessarily generate Goldilocks returns for investors and, with implied returns already low, the risk-adjusted returns from cash are becoming much more attractive.

The Montgomery Global Funds own shares in Amazon, Apple and Facebook

This article was written on 20 November 2017. All share and other prices and movements in prices are on this date.

Why do we own Facebook?

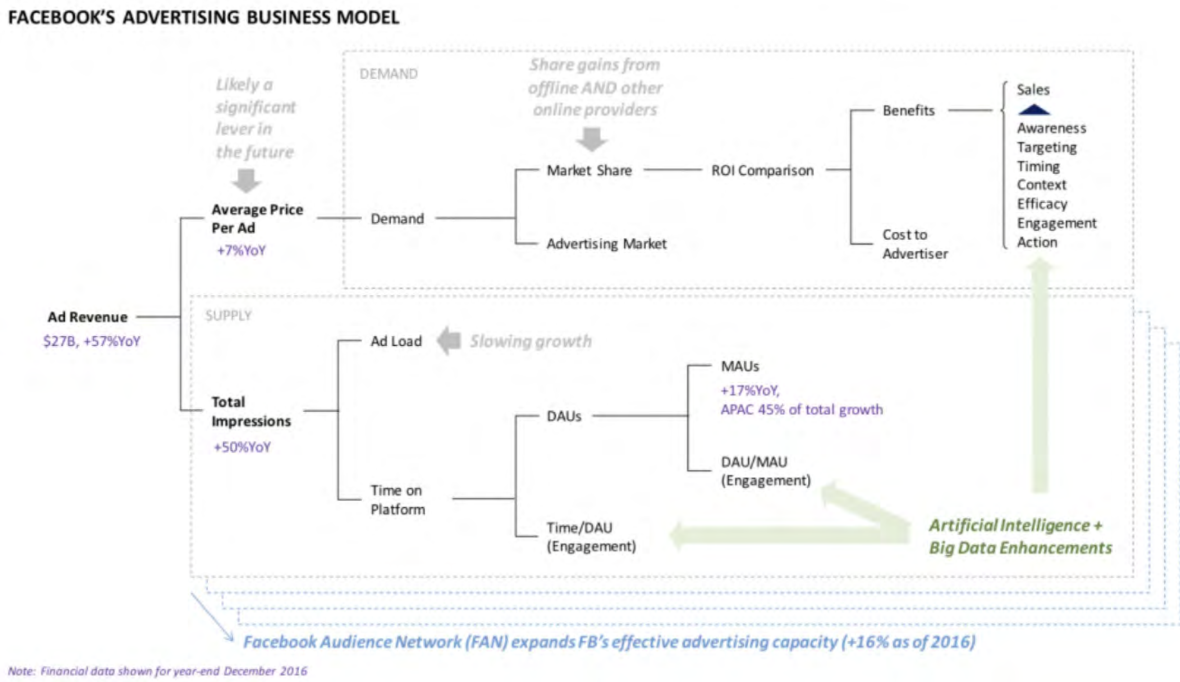
Andrew Macken, Portfolio Manager

One of the world's great online technology platforms today is a little business called Facebook (NASDAQ: FB). Facebook is the clear winner when it comes to social networking in the world (ex-China). By Andrew Macken.

At Montgomery Global, we believe the online technology platform is a special business model that, if successful, will deliver owners supernormal returns for a long period of time. As positive network effects compound the value of the platform's ecosystem for all users, the ecosystem grows, and with it does the scale of the platform, its access to valuable data and its ability to monetize new (or acquired) technology over the existing platform.

One of the world's great online technology platforms today is a little business called Facebook (NASDAQ: FB). Facebook is the clear winner when it comes to social networking in the world (ex-China). With 1.9 billion monthly-active-users (MAUs), Facebook has built an enormous and ever-growing database of personal information on more than quarter of the world's population. And it has created an advertising platform upon which advertisers can target cohorts of Facebook members based on highly-specific criteria. This, in-turn, dramatically increases the efficacy of advertising on the Facebook platform – and hence, a rapidly growing amount of ad spend has been diverted towards Facebook over recent years. (Facebook's advertising revenue grew by +51 per cent in its most recent quarter compared to one year prior).

The key to understanding Facebook is to understand its advertising model. We believe Facebook's advertising business model can be summarised by the chart below. Essentially, Facebook can generate both "demand" for its advertising by improving its efficacy; and "supply" of impressions by driving up user engagement and time spent on its properties, ad loads (though this has almost maxed out) and via non-Facebook mobile sites following the creation of the Facebook Audience Network (FAN). Over time, we believe Facebook could charge a lot more for the value it offers advertisers. Said another way, the vast majority of Facebook's revenue growth to date has been driven by market share gains, not pricing power.

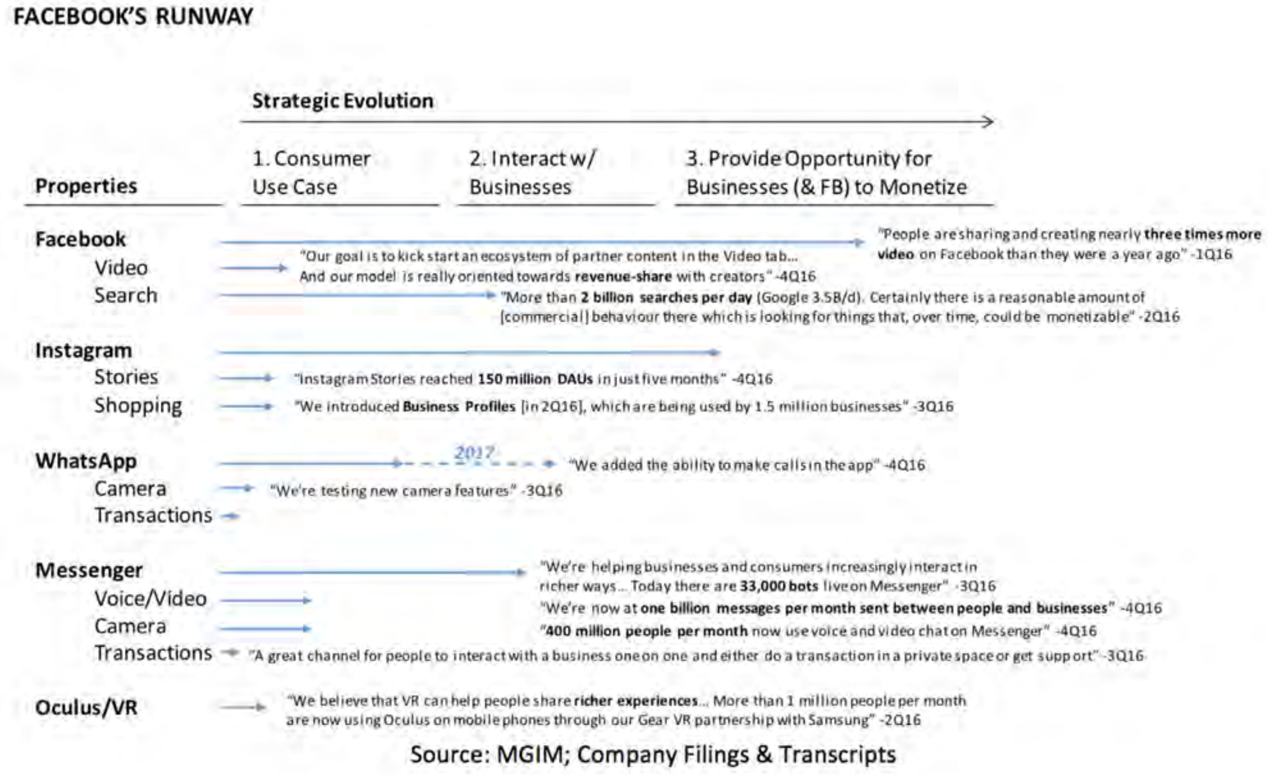


Source: MGIM; Company Filings

Facebook's advertising business, driven by four million active advertisers, is highly-diversified and, we believe, resilient. Facebook's advertising revenue growth has been broad-based across all regions, marketer segments and verticals. Its largest 100 advertisers represent less than 25 per cent of the company's total advertising revenues. The business generates roughly half its revenue in the US, with the remainder stemming from around the world (ex-China, North Korea and Iran in which Facebook is banned).

As if this advertising platform were not enough, Facebook owns a number of other properties that are in only the very early stages of monetisation. Now, before Facebook will attempt to monetise a property, it will go to great lengths to build a consumer use case or value proposition. Following this, it will then facilitate the interaction with businesses on the property. Then, and only then, will Facebook attempt monetisation. This is the company's "strategic evolution" which it follows.

Shown on the next page are Facebook's properties and the stages they are at with respect to their respective strategic evolutions. And Facebook's other properties are social network behemoths in their own right. Consider that Instagram already has around 600 million MAUs, WhatsApp 1.2 billion MAUs and Messenger more than 1 billion MAUs. Yet these properties are generating an almost-negligible amount of revenue at the moment. And we know messaging apps can become wildly profitable – just look at Tencent's WeChat messaging app in China! From this perspective, we believe Facebook has a long runway ahead to continue growing its revenues and earnings.



Of course, understanding the extraordinary extent of Facebook's business quality is a necessary, but insufficient, condition for us to own its stock. We also need to ensure that the business is undervalued. In the case of Facebook, we believe the growth expectations built into the stock's current price, while strong, remain conservative relative to the opportunity that lies ahead for the Facebook platform. Remember, successful online technology platforms are uniquely attractive in the sense that, as they grow, so too does their ability to add value to all who participate in their ecosystem. We believe Facebook is an extraordinarily high-quality business with an intrinsic value that has not yet been fully recognised by the market.

The Montgomery Global Funds own shares in Facebook

If you want easy access to online technology platforms invest in the Montgomery Global Equities Fund (Managed Fund) (ASX: MOGL) and receive or reinvest a minimum targeted yield of 4.5% p.a. To access the PDS and find out more, please visit www.montinvest.com/mogl.

This article was written on 27 November 2017. All share and other prices and movements in prices are on this date.

Why we prefer to take a long-term view

George Hadjia, Research Analyst

There is a case to be made for taking a longer term view when holding stocks, particularly for high quality businesses. Writes George.

Benjamin Graham, the mentor to Warren Buffett, once said: "In the short run, the market is a voting machine but in the long run, it is a weighing machine." In other words, in the short run, there is a lot of market noise and investor emotion that can drive stock prices. But, over time, stock prices typically reflect the fundamentals of the underlying business.

Whilst stock prices can swing like a pendulum, reflecting periods of unbridled optimism as well as undue pessimism, there is a case to be made for taking a longer term view when holding stocks, particularly for high quality businesses.

On a recent trip to the US, what stood out was the overwhelming short termism of many of the other investors I spoke to. At company meetings I attended, questions were pointed at the next quarter and whether the company was likely to beat or miss their earnings guidance. Many of the investors thought about stocks, and invested, with much more of a trading mentality.

While trading is a perfectly fine way to make money, and some traders are fantastic at it, it is not something we profess to know a great deal about. Rather, we stick to our process which is picking under-priced businesses that we feel have a high probability of appreciating in value over time.

You might ask why have we chosen this approach of holding stocks for the longer term. The Montgomery Global team has a proclivity to hold undervalued stocks where time is needed for either: (i) the stock price to converge with our estimate of that company's intrinsic value; (ii) the business value to grow; or both (i) and (ii).

Whilst we welcome short term market noise, given the mispricings and opportunities it often throws our way, a longer term holding period is usually required for our investment theses to play out. You typically need time for these value gaps to close, whether that be due to positive business developments, or broader recognition by the market of the stock being undervalued.

The greatest area where a long time horizon serves as an advantage is for so-called "compounders" – that is, companies that are able to employ capital at very high rates of return and thus compound the value of the business over time. Time is the friend of these businesses, and significantly wealth can be generated by identifying these businesses, buying them cheaply, and holding them for a long time.

Another advantage of a longer investing time frame is the avoidance of excessive transaction fees, such as commissions and taxes, that occur through frequent trading.

Furthermore, a less recognised benefit is the compounding of the deferred tax gain component. You see, when you hold a stock that appreciates in value, you only have to pay tax if you sell your investment. For stocks that appreciate over long periods, investors benefit from compounding the deferred tax gain, or the portion of their investment gain that would need to be paid out as capital gains tax if they sold. As soon as you waver and sell out, then you create a tax event and reset the deferred tax compounding clock.

Whilst there is more than one way to make money in the stock market, investors need to ultimately identify an investing style that matches their own temperament and needs.

This article was written on 27 September 2017. Any mention of prices and rates are on this date.

How changes in the AUD affect global-facing businesses

Stuart Jackson, Portfolio Manager

The strength of the Aussie dollar relative to other currencies has a big impact on exporters, and on businesses that generate earnings overseas. By Stuart Jackson.

The gyrations of the Aussie dollar are a constant focus of media attention. And well they might be. Because, apart from reflecting our national economic health, the strength of the Aussie dollar relative to other currencies has a big impact on exporters, and on businesses that generate earnings overseas.

Having fallen significantly from its lofty levels above parity with the USD maintained between 2011 and 2013, the AUD has recovered somewhat over the last 18 months. This has come on the back of a combination of a weakening USD as well as improving commodity prices.

The Trump tax plan has reignited the reflation trade, and in combination with quantitative easing (QE) Tapering bolstering the USD, the AUD has fallen from its recent highs.

Movements in the AUD impact company earnings in a number of ways. The main two types of impact are though translation and transaction exposure.

Translation exposure refers to companies with earnings generated from overseas operations. These companies will have both revenue and costs denominated in foreign currencies. The impact of a fall in the AUD will generally increase the AUD profit generated by the business by a similar percentage as the increase in revenue and costs. Some examples of companies with high levels of translation exposure are Brambles, Amcor, Boral and Computershare.

Transactions exposure generally impacts companies that export products from one country to another. As a result, a proportion of the company's costs will be denominated in a different currency to its revenues. This can lead to significant movements in product margins as a result of changes in exchange rates. Resources companies and other exporters like wine producers have high levels of transactional exposure to the AUD. Another source of transactions exposure is through input costs that are denominated in foreign currency.

Given changes in the AUD impact margins for companies with transactions exposure, the earnings of these companies tend to be far more significantly impacted by exchange rate movements.

MOVEMENTS IN THE AUD IMPACT COMPANY EARNINGS IN A NUMBER OF WAYS . THE TWO MAIN TYPES OF IMAPCT ARE THROUGH TRANSLATION AND TRANSACTION EXPOSURE.

The market will generally anticipate the impact of recent movements in the AUD on company earnings. However, projections tend to use simplistic sensitivity ratios. The actual impact is generally more difficult to estimate due to secondary impacts, particularly when underlying product pricing is less visible.

The wine industry provides a typical example of where basic earnings sensitivities can overstate the benefit a company's earnings will generate from the fall in the AUD.

Wine exports are generally priced in the currency of the destination market. Movements in local currency pricing will be driven by the market power of customers and the activity of competitors. The fall in the AUD should lead to a significant increase in gross margins for Australian wine producers due to the impact it has on unit revenue in key export markets (US, UK) while leaving unit costs unaffected. For example, Treasury Wine Estates (ASX: TWE) indicated in its 2017 result presentation that a 10 per cent change in the AUD against the USD and GBP would impact group earnings before interest and taxes (EBIT) by over 10 per cent.

FOR COMPANIES WITH TRANSLATION EXPOSURE, THE KEY TO DETERMINING THE NET IMPACT ON MARGINS IS DETERMINING WHETHER THE BUSINESS HAS COMPETITORS THAT HAVE COST BASES DENOMINATED IN OTHER COUNTIRES.

However, two factors must be remembered. The first is that this sensitivity is net of the impact of hedging. As of a month ago, TWE had hedged 65 per cent of its exposure to the GBP and 55 per cent of its exposure to the USD if the AUD moved above US$0.79 and £0.59. This is a temporarily benefit that merely delays the impact of AUD movements.

Secondly, wine companies such as TWE are selling into highly concentrated retail markets. Additionally, a number of other wine producing countries are also benefiting from depreciating currencies, namely producers from Chile, South Africa and Argentina. The average AUDUSD spot rate increased 3 per cent in the 12 months to June 2017. This compares to a 4 per cent rise in the Chilean Peso, a 22 per cent fall in the Argentine Peso and a 6 per cent rise in the South African Rand.

The Australian industry has merely maintained its FX determined cost competitiveness on unit costs relative to a large proportion of its competitor base in FY2017.

Retailers are also able to calculate the benefit of the falling AUD to the producer, providing them with a strong argument in negotiating reductions in local product prices. The increased competitiveness of producers from Chile, Argentina and South Africa, along with other producers in Australia provides the retailers with leverage in negotiations. As a result, at least some of the transactional benefits from the falling AUD are likely to be competed away.

For companies with translation exposure, the key to determining the net impact on margins is determining whether the business has competitors that have cost bases denominated in other countries.

The current AUDUSD spot rate is around 4 per cent higher than the average for FY2017, indicating that, at current exchange rates, the AUD will be a drag on growth in FY2018.

The flipside, and potentially underappreciated benefit, is for companies focused on the domestic Australian market with local cost bases that primarily compete with imports. While a falling AUD might not have an immediate impact on competitor pricing and activity, over time the willingness of import competition to absorb the impact of the weaker AUD is likely to dissipate. The opposite applies during periods of sustained appreciation of the AUD.

This article was written on 5 October 2017.
Any mention of prices and rates are on this date.

Does it make sense to own Wesfarmers?

Tim Kelley, Head of Research

Why would we take a positive view today on WES? By Tim Kelley.

Followers of our articles may raise an eyebrow at the sight of Wesfarmers (ASX: WES) recently finding its way into the top ten holdings in The Montgomery Fund. Over the years, we have written various articles on the headwinds facing the Australian supermarket industry, with a particular focus on the rise of discounters like Aldi, and more recently we have observed that Woolworths has taken steps to reverse a long trend of weak like-for-like sales performance, and begun to retake market share.

So why would we take a positive view today on WES?

Let's start at the beginning. One of the tools we use early in our process to identify investment ideas is a machine learning model which has been trained to distinguish between good and bad investment candidates using all of the available financial statement information, broker forecasts and market trading data. While this system makes its share of mistakes, the evidence indicates that it gets more right than it gets wrong and, importantly, it provides an unbiased assessment of investment merit, free from any prejudices and biases that human nature might bring to the task.

This system imposes a discipline of reconsidering our view of companies where our initial instinct might be to pass. Discipline is good.

In the case of WES, potential biases are easy to see. Back in 2014, we sold out of our holding in Woolworths (ASX: WOW) after considering the likely impact of Aldi to Australian supermarket margins. At that time, we concluded that the market was being too optimistic about WOW's future margins, and that the downside significantly outweighed the upside.

So, what has changed since then?

One important change is that what may have been insightful in 2014 is rather more obvious to the market today. 2014 was a good time to sell WOW, ahead of a steady share price decline into mid-2016, but since then the market has taken account of the Aldi threat and things have moved on.

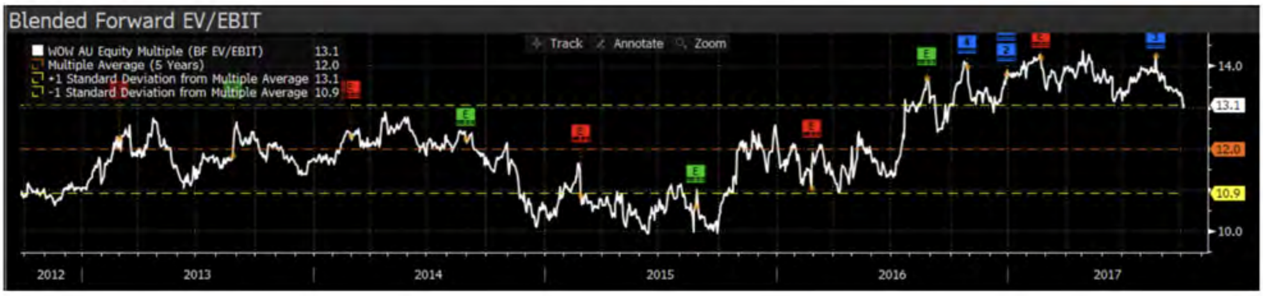
In addition to the WOW share price declining, WOW and WES have been working hard to reduce the opportunity for discounters like Aldi by lowering costs and prices. For example, where Aldi previously had a significant labour cost advantage through operating the most efficient checkout lines, now the larger supermarkets increasingly use self-serve checkouts, automated ordering and shelf-ready packaging to lower the labour component of costs, and erode Aldi's advantage. Profit margins that previously were at world-leading levels now look increasingly sustainable, and as Aldi's market share grows, marginal gains become increasingly difficult as a natural limit approaches.

In short, that 2014 insight into Aldi may have been a good one, but when an insight becomes common knowledge, it can transform from a useful investment edge into an unhelpful cognitive bias. This one looks to be past its use-by date.

A more "current" argument against owning WES is the recent improvement in like-for-like sales growth for WOW. After many years of lagging performance, WOW now appears to be gaining share with improved execution, and broking analysts expect that this will continue for some time.

That may well prove to be the case. However, it is far from certain. It is difficult from the outside to see whether WOW now has a sustainable execution advantage over WES, but if the market believes that it does, then there is potentially more scope for WES to surprise on the upside than there is for it to disappoint.

WES and WOW are complex businesses with several components to the valuation argument. However, a simple analysis will help illustrate the idea. Below we see a 5-year history of the ratio of enterprise value (EV) to Earnings Before Interest and Taxes (EBIT) for each of WOW and WES.



Source: Bloomberg

The history shows that the EV/EBIT ratio for WOW has recently moved to a high point, while for WES it has moved to a low point. In part, this may reflect the market moving to price in WOW's improving performance in recent times. If that is the case, the numbers suggest that this idea may have played out by the start of 2017, and now offer little by way of investment edge.

Stepping back from the numbers, it certainly feels as though sell-side and buy-side analysts should by now be well aware of WOW's recent sales performance, and be making allowance for this in earnings forecasts. Accordingly, this idea may now have a limited contribution to make to an investment thesis today.

Again, this analysis is simplistic, and glosses over issues like ongoing losses at Big W, the impact of coal earnings for WES, and the fact that a large part of the value of WES lies in Bunnings, so it is probably best to view it as illustrative of the concept, rather than conclusive.

And to be fair, when we do analyse WES in greater detail, we don't find what we would consider a compelling valuation case. While it looks better than it has in the past, our analysis still doesn't show WES to be cheap in absolute terms.

The thing to note, however, is that in the current market, a high-quality business trading at a compelling valuation is a rare beast. In fact, any sort of business trading at a compelling valuation today is a rare beast. Low interest rates appear to have driven valuations to uncomfortable levels, and as a result The Montgomery Fund is at the high end of its normal cash range. There is no telling when attractive absolute valuations might again emerge, but until they do we remain cautious, and try to find the opportunities that offer the best balance of risk and reward.

We own WES, for a couple of reasons. Firstly, we see a relatively secure income stream protected by attractive industry structures (in both supermarkets and home improvement) which allow incumbents to earn returns comfortably above the cost of capital. Secondly, we see limited downside risk due to technological, businesses model, regulatory or other businesses disruptions. Thirdly, we see some scope for WES to surprise on the upside, given that the market is arguably focused on the negatives (including concerns around a possible price war). Finally, in an expensive market, we think it makes sense to own businesses that can generate attractive returns on capital and which should weather any market turbulence in good shape.

It may not be the most exciting thing an investor could own today, but long-term success sometimes means avoiding exciting investments.

The Montgomery Fund owns shares in Wesfarmers

This article was written on 10 October 2017.
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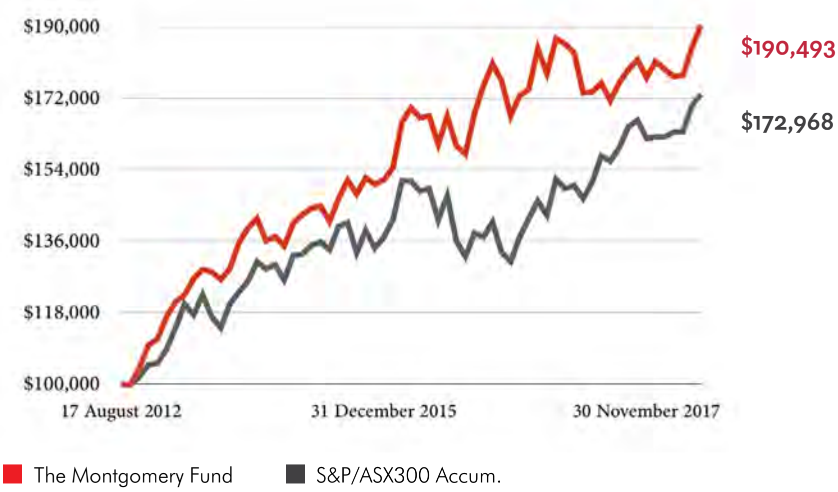

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