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REPORTING SEASON HIGHLIGHTS OPPORTUNITIES FOR VALUE INVESTORS

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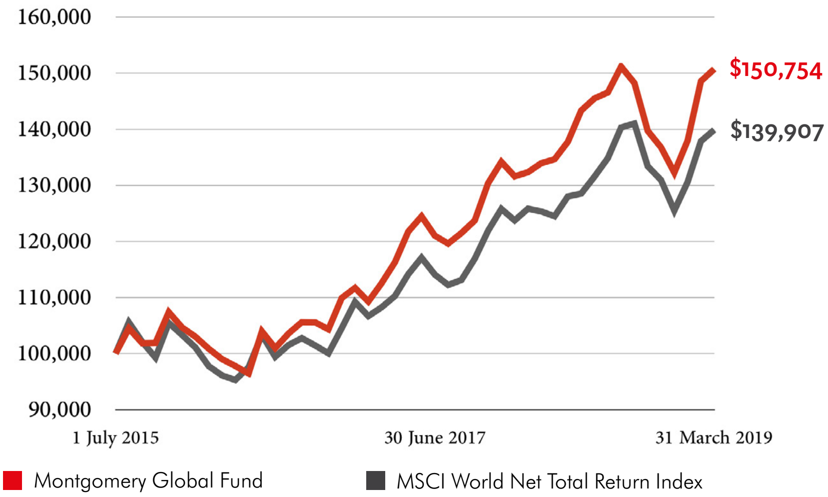

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FROM THE EDITOR

Welcome to our first *Best of The Best* Magazine for 2019. In aggregate, reporting season was somewhat underwhelming with the better than expected results for the first half of the year, offset by weaker than expected outlook statements for the remainder of the year. But now that reporting season is well behind us, investors have returned somewhat predictably to thinking about the macroeconomic, geopolitical and financial picture.

In Australia, our long-held prediction of a significant slowing in housing activity has come to pass with Morgans reporting; "New residential listings…appear to be at an all-time low for both Sydney (-20.9 per cent for the 28 days ended March 17 compared to the prior corresponding period) and Melbourne (-15.5 per cent). Based on the data we have been able to access; annual housing churn rates appear to be 2.7 per cent in NSW and 2.6 per cent for Victoria - lower than the depths plumbed in the GFC and the two preceding recessions."

A slowing domestic economy, plunging retail sales and the forthcoming slide in construction activity – which will follow the reported near-40 per cent plunge in building approvals – has seen bond rates collapse to record lows. And with the RBA stating that "credit conditions tightened more than was probably required" and APRA digging its heels in against pressure to lower the stressed mortgage serviceability rate from 7.25 per cent, it is likely that the RBA will cut rates this year and perhaps more than once.

While we are some way off a recession, there's certainly more abundant speculation that we are on the precipice. Investors need to be reminded however that there's a big leap required from 'post-peak' growth to negative growth. Today we are 'post-peak'.

The conditions are similar in the US and the US Federal Reserve has been working hard, at various public appearances including the recent Credit Suisse Asia Investment Conference, to assure investors that they have their backs. Rates being cut to zero again, and a resumption of QE are all on the table should investors fear a recession or worse, one actually transpires.

The consequence of all this is that despite a deteriorating earnings and economic growth backdrop, equity prices remain generally elevated. Remembering that the higher the price one pays, the lower one's return, we should be mindful that risk is positively correlated to prices. If prices are high so is the risk.

If you have never read Value.able now would probably be a good time to purchase a copy and get prepared for high quality value investing opportunities. Alternatively, it might be worth starting to think about preparing to invest additional funds in the market at some point this year or next.

Copies of Value.able are available here.

Keep in mind being prepared for value investing opportunities is always going to be worthwhile. There is usually an investment or two worth investigating, even when markets are expensive and growth generally is slowing. By way of example, we have been delighted, to have recently invested in a medical technology company which develops, manufactures and distributes an innovative regenerative product with both medical and cosmetic applications.

I hope you enjoy reading our latest edition of *Best of The Best* and we remain delighted to be working for you.

Roger Montgomery
Chief Investment Officer

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Reporting season highlights opportunities for value investors

Roger Montgomery, Chief Investment Officer

An impatient market often overreacts to the failure to meet short term expectations, producing share price volatility, which provides an opportunity for longer term value investors. Writes Roger.

While the recent reporting season painted a mixed picture about the outlook for Australia, it also left me optimistic. Any bouts of volatility this year will provide investment managers like us with the opportunity to find value among quality businesses. Let me explain.

In aggregate, results for the first half of financial year 2019 were marginally weaker than expected, but remember these results are looking backwards all the way to July 1, 2018. The material drops in retail foot traffic and spending, construction and home sales all occurred towards the very end of the half year. That weakening just before Christmas saw companies offer very weak guidance for the remaining five months of the year, and in some cases for 2020. Companies that downgraded guidance included Westfield, Scentre Group and Coles. Companies that upgraded included Ansell, Computershare, Corporate Travel Management and Jumbo Interactive.

Interestingly there were some impressive share price reactions to results but in many cases – I am thinking of Domain, Mortgage Choice and Automotive Holdings – the results weren't amazing, it was just that expectations were much lower.

Last year earnings for the top 100 companies grew by almost seven per cent but following recent downgrades, earnings are now expected to grow by between 2.5 and 3.5 per cent. Importantly, most of that growth will be generated by resources stocks.

Take resources and financial stocks out of the picture and industrial earnings are expected to decline by between three and four per cent.

This year should be a very interesting one indeed, and with opportunities for value likely to be presented at any moment, investors will benefit from being prepared.

When earnings are going backwards, institutional investors pressure companies to reduce costs and delay research and development (R&D) or reinvestment; but cutting costs can take time, and R&D is necessary for future growth. Consequently, an impatient market often overreacts to the failure to meet short term expectations, producing share price volatility, which provides an opportunity for longer term value investors. And given the industrials index excluding financials is trading on almost 20 times earnings, volatility could be triggered at any moment.

We certainly believe that the weakening aggregate earnings picture is at odds with the near 10 per cent rally in the market in January and February. I suspect the massive Chinese stimulus and the US Federal Reserve's decision to ease off the gas with respect to rate hikes may have had a lot to do with recent market strength.

One positive out of reporting season was the decision by some companies, including Flight Centre to pay large dividends. This may have been motivated by concerns a Labor election victory will reduce the value of franking credits to investors. What was surprising was that more companies didn't follow Flight Centre's lead. Given the surplus franking credits held by Harvey Norman and JB Hi-Fi, one suspects the deteriorating business outlook may have usurped the desire to be more generous.

The recent rally in the market has stretched valuations again and while we invested a reasonable amount of cash during the December quarter sell off, we ceased investing as the market rallied. If the rally continues we may end up trimming some of our holdings.

Two emerging themes

Two themes emerged during reporting season that are worth highlighting.

The first is that there is a group of smaller companies doing well overseas. If you believe the Australian economy may slow, which could put pressure on the Australian dollar, then these companies are worth investigating as they benefit from repatriating foreign earnings. This group of companies includes IDP Education and Reliance Worldwide (both owned by The Montgomery Fund), and Bellamy's, A2Milk, Appen and WiseTech Global. The prices currently required to invest prohibit sensible value investors from participating in this latter group.

The second theme is that there is a group of companies that are only just entering a period of difficulty. These are exposed directly to home sales – think Villaworld and AV Jennings – or exposed indirectly through the sale of goods that are used to furnish and finish a home – think Bunnings, Metcash, Adairs, Beacon Lighting, Harvey Norman, Nick Scali and JB Hi-Fi-owned The Good Guys.

This year should be a very interesting one indeed, and with opportunities for value likely to be presented at any moment, investors will benefit from being prepared.

The Montgomery Funds own shares in IDP Education and Reliance Worldwide. This article was prepared 15 March with the information we have today, and our view may change. It does not constitute formal advice or professional investment advice. If you wish to trade these stocks you should seek financial advice.

This article was written on 15 March 2019. All share and other prices and movements in prices are on this date.

Blue skies ahead for Sydney Airport?

Joseph Kim, Senior Research Analyst

Joseph identifies Sydney Airport's revenue streams and any potential impacts on its key earnings drivers.

Sydney Airport is Australia's busiest airport. Its owner – Sydney Airport Holdings (ASX:SYD) – has profited from Australia's growing attraction as a tourism destination, and the airport's monopoly position. So what does the future hold for its key earnings drivers?

SYD has stable long-term returns leveraged to passenger traffic. It generates revenue in 4 primary ways:

- **Aeronautical Services** – the charge to airlines for use of terminal and airfield infrastructure on a per passenger basis. Charges are based on a commercial agreement with airlines, the largest of which is between the Board of Airline Representatives (BARA), which covers 32 member airlines including Qantas and Virgin. Large users like the latter also have separate agreements in place.

  Aeronautical services represent approximately 50 per cent of total revenue. The aeronautical side is monitored by the ACCC under a 'light-touch' regulatory regime which is reviewed every 5 years by the Productivity Commission.

- **Retail** – SYD leases 244 stores and licenses advertising rights in and around its terminals, of which the International terminal T1 is accountable for more than 80 per cent of retail revenue. Lease agreements include a base rent component with revenue share post sales targets being met. Retail represents 23 per cent of total revenue.
- **Property and car rental** – SYD leases property sites and buildings spanning airport lounges, airline offices, freight facilities site hangars, hotels and car rental areas. The airport has over 650 operating leases with average occupancy of around 99 per cent. SYD also owns 2 hotels operating at the domestic airport (IBIS and Mantra). Property and car rental is 1 per cent of group revenue.
- **Transportand Landside Operations** – revenue generated from car-parking and fees charged to access landside areas. The airport has over 18,000 carparking bays with a roughly even split between international, domestic and at-distance. Transport and landside operations represents 11 per cent of total revenue.

Most of SYD's commercial contracts and revenue is inflation-linked, which provides a natural hedge against rising interest rates (as higher interest rates are expected to be a function of higher inflation).

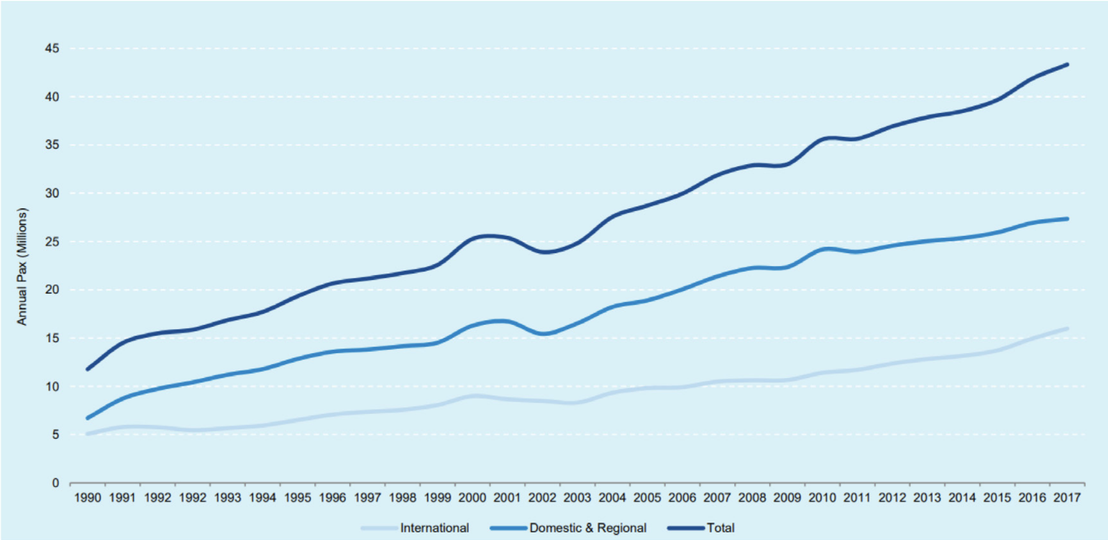
Simplistically speaking, the business can be split between a light-touch regulated infrastructure asset and a high-end shopping centre and commercial building / office space.

What is the outlook for SYD's key earnings driver?

In the commentary on the previous page we established how the company generates revenue, it is important to understand the drivers of the revenue – for SYD, is primarily growth in passenger numbers. Passenger growth is important given its direct linkage to aeronautical revenues and car-parking revenue, as well as increased demand for retail leases and property services.

SYD has previously disclosed international passengers generate approximately 3.5x the revenue of domestic passengers.

Sydney Airport Passenger Growth



Source: Company presentations

This chart shows the longer-term trends in passenger numbers at Sydney Airport. The airport has benefited from strong structural tailwinds, which includes falling real airfares, growth in middle class incomes, increasing demand for international travel and Sydney's increasing attractiveness as an international tourist destination – which augments overall population growth.

Domestic passenger numbers have also benefited from some of these structural trends but is more heavily influenced by local factors such as the economic outlook.

While passenger traffic is not immune to short-term fluctuations (such as the drop in 2001 due to the September 11 attacks), it would be safe to assume growth over the long-term given the above, as airlines continue to add services.

Sydney Capacity Additions in 2017-2018

Emirates	Dubai	356,000
Qatar	Doha	260,000
China Airlines	Taipei	223,000
United Airlines	Houston	184,000
Qantas	Auckland	175,000
Etihad	Abu Dhabi	123,000
Qantas	Osaka	92,000

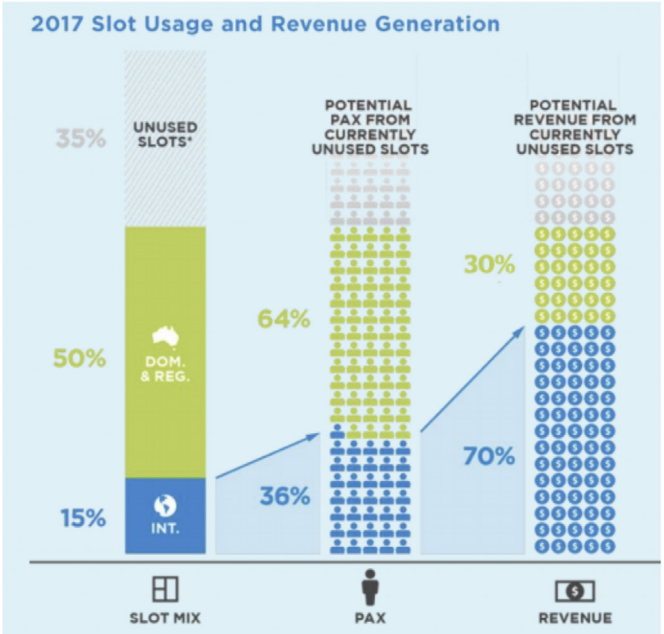
Cathay Pacific	Hong Kong	65,000
Beijing Capital	Qingdao	58,000
Asiana	Seoul	44,000
Samoa Airways	Apia	35,000
Hainan	Haikou	21,000
Tianjin	Zhengzhou	17,000
Cebu	Manila	17,000

Source: Company presentations, Montgomery

Capacity considerations

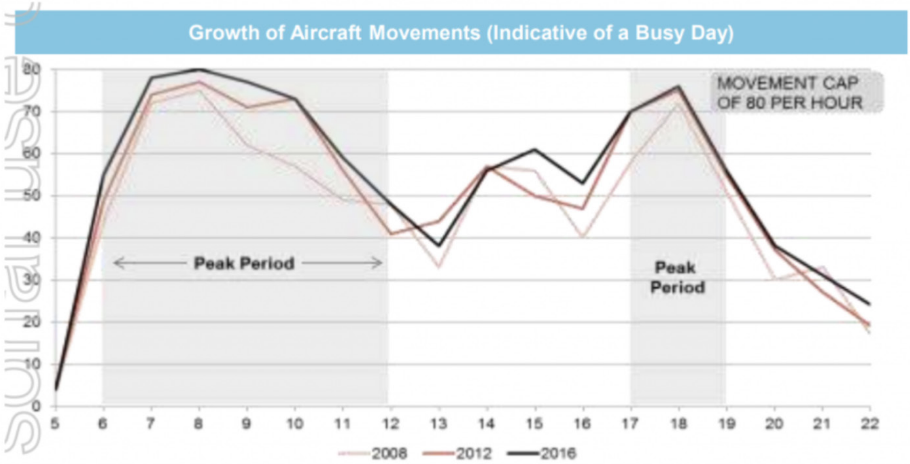
One aspect to consider when forming longer-term passenger estimates is the natural limit the airport has in terms of total Air Traffic Movements (ATM). Sydney Airport operates under legislated restrictions which restrict total passenger numbers including:

- Restriction in air traffic movements to 80 per hour, or 20 per 15 minutes;
- A curfew operating between 11pm to 6am; and
- Regional ring-fencing whereby around 15-20 per cent of slots be available for regional flights.



Source: Company presentations

Based on current air traffic movements, there remains significant headroom for additional flight movements and passenger growth, with Sydney's estimated utilisation at 65 per cent. However, it is worth noting movements in peak hours are significantly higher and hit the regulated cap, so additional growth is more reliant on "up-gauging" (larger aircraft), "peak-spreading" (more movements in lower-peak hours) or an alleviation of movement restrictions.



Source: Company presentations

<u>How will the introduction of a second airport impact Sydney?</u>

In 2018, the Commonwealth Government approved the construction of Western Sydney Airport (WSA) at Badgerys Creek. Set to open in 2026, WSA will most likely divert some of Sydney Airport's passenger traffic to WSA. As a new entrant to what has historically been a natural monopoly, Western Sydney Airport is posed as a potential longer-term risk for investors given the uncertain impact on Sydney Airport's passenger growth.

While the overall impact is not immediately clear, studies of cities with multiple airports with separate owners has shown a level of increased competition in both pricing and attracting passengers. However, given the proximity of Sydney Airport to Sydney's CBD vs WSA, it is unlikely there will be significant migration of premium international / domestic passengers to WSA. In fact, migration of lower yielding, low-cost carrier domestic passengers and an easing of Sydney's regional slot requirement may improve profitability as Sydney Airport is close to capacity on peak slots already.

You can read more on Sydney Airport here and here.

This article was written on 15 February 2019. All share and other prices and movements in prices are on this date.

Our view on Challenger

Andreas Lundberg Joint Portfolio Manager

Andreas takes a look at Challenger's trading update in January which caused a share price decline. Did the market over react?

At the end of January, the market took a sledgehammer to the share price of Challenger (ASX:CGF) following a trading update. Clearly, many investors did not like what they saw. But was the update really that bad?

In this article, I will attempt to dissect the update. First, let's look at the headlines from the release:

- In total, Challenger expects to report normalized net profit before tax of $270 million for the six months to December 2018 and $545-565 million for the year to June 2019.
- This guidance has been negatively impacted by a couple of factors since the Annual General Meeting on 26 October 2018 when management expected growth of normalized profit before tax of 8-12 per cent which implied a result between $591- $612 million for the year to June 2019.
- For the six months to December 2018, it also compares to the consensus forecast (the average of the sell side analysts) of $293 million for 1H19.

The factors impacting the results in 1H19 are:

1. Lower yield cash distributions from the absolute return portfolio of approximately $13 million. This portfolio has historically generated a cash yield of 6 per cent per annum and contains both complete market neutral funds and long-short funds that can have a long/short bias. This portfolio is around $800 million in size and for the six months to December 2018 only achieved a yield of 1.3 per cent which resulted in the $13 million short-fall.
2. Lower performance fees in their fund management operations of about $4 million.
3. They have also experienced some impact from entering into a collar arrangement on part of their equity portfolio (a couple of $m) and some lower return from them moving the portfolio towards higher rated fixed income assets and exiting some property investments.
4. In addition, they announced that they anticipate an investment experience loss of about $194 million in 1H19 meaning that the statutory reported results are likely to be just $6m.

In total, the impact in 1H19 vs. their budget/consensus was around $23 million compared to the normalized profits. It looks like management basically doubled that figure to arrive at the ~$45 million downgrade to annual profits they communicated in the trading update.

Before we look at each of these factors, it is worth reminding ourselves of the way that Challenger reports their results:

- They start by applying an expected return on each of the different asset classes in their investment portfolio. The expected return is based on the long-term performance of the different asset classes (equities, fixed income, property, infrastructure etc.)
- The purpose of this is to be able to show what the underlying performance of the business is disregarding short term movement in asset prices which can drown out the underlying performance of the business. Given that Challenger matches the duration of its assets (its investments) and liabilities (the annuities it writes), short term asset price movements which leads to mark-to-market movements in the results are of less importance over time, it should adjust towards a long-term average. This is why the company gives guidance based on a "normalized" basis.

- Challenger then reports an "investment experience" item which shows the mark-to-market gains or losses they actually experience in the period based on what asset prices have actually done.

Let's now analyse each of the above listed factors impacting the results:

1. The $13 million impact from lower return on the absolute return portfolios.

- This can at first sight be a bit confusing. Why was this not reported through the investment experience line? The reason for this is that this is actual cash distributions they receive and not a change in value of an asset that they hold which can change in the future and hence it is reported as part of the underlying performance.
- There was clearly a long bias to some of the funds included in this portfolio and the very weak equity markets towards the end of 2018 had a negative impact on these funds which impacted the cash that they paid out. We should note that equity markets in January were generally very strong and if the funds continued to be long biased, a lot of this could reverse in 2H19 if markets hold steady from here.

2. The $4 million lower performance fee from the fund management operations.

- About 21 per cent of the FUM that Challenger manages is subject to performance fees.
- Challenger has not said anything about their investment performance in the period (they normally only comment at full release of results) but with equity markets falling sharply in late 2018, even if the relative performance is still good, there are usually clauses preventing a payout of performance fees in a down market.
- Either way, performance fees are a very small part of the overall income for Challenger and not something that the market is putting a high value on.

3. The cost of entering into an equity collar (basically an option strategy that limits both the upside and the downside of a portfolio) and the move of their fixed income portfolio to higher rated fixed income securities and exiting some properties.

- This is in my mind the most interesting part of the announcement.
- It is clear that it impacts the immediate results as the expected return of higher rated fixed income securities is by nature lower than that of lower rated securities and indeed commercial property.
- The counter side of this is that it lowers the volatility and default risk of the investment portfolio. This means that the capital that Challenger must set aside to cover their future liabilities (the annuities they write) is lower and it frees up capital either as an additional buffer or enables a higher rate of future growth without having to ask shareholders to put in more money to fund the growth.
- This should have the effect of lowering the cost of equity for Challenger and increasing the price that investors should be prepared to pay for the share and counteract the lower profitability resulting from the move to more secure investments.

4. Finally, the investment experience loss of $196 million.

- This is predominantly related to equities ($117 million) due to lower equity markets and some to fixed income ($34 million) as credit spreads widened some in 1H19.
- Again, this is not realized a loss and given the strong equity market in January, a reasonable portion of the equity related loss is likely to have reversed already, meaning that we could see a positive investment experience result at the full year results if equity markets stay at a current level.

If we look at the market's reaction to the trading update, Challenger has lost about $1 billion in market capitalization. This means that the market has put about a 32x P/E on the downgrade of $45million pre-tax which equates to $33 million post-tax. Given that the lower realized distributions from the absolute return portfolio and the lower performance fees which totals $34 million on an annualized basis and which can possibly be considered "one-offs", we can alternatively say that the market has put a P/E of well over 100x on the reduced profits from the rest of the downgraded guidance (being $45 million-$34 million = $11 million pre-tax or just over $8 million after tax). I will leave it up to the reader to judge if you think this is appropriate.

The Montgomery Funds own Montgomery Global Funds own shares in Challenger. This article was prepared 11 February with the information we have today, and our view may change. It does not constitute formal advice or professional investment advice. If you wish to trade Challenger you should seek financial advice.

This article was written on 11 February 2019. All share and other prices and movements in prices are on this date.

One important aspect of active management

Andrew Macken, Portfolio Manager

Changes to the portfolio's exposures at different stock price levels is one of the most basic, yet important aspects of active funds management. Writes Andrew

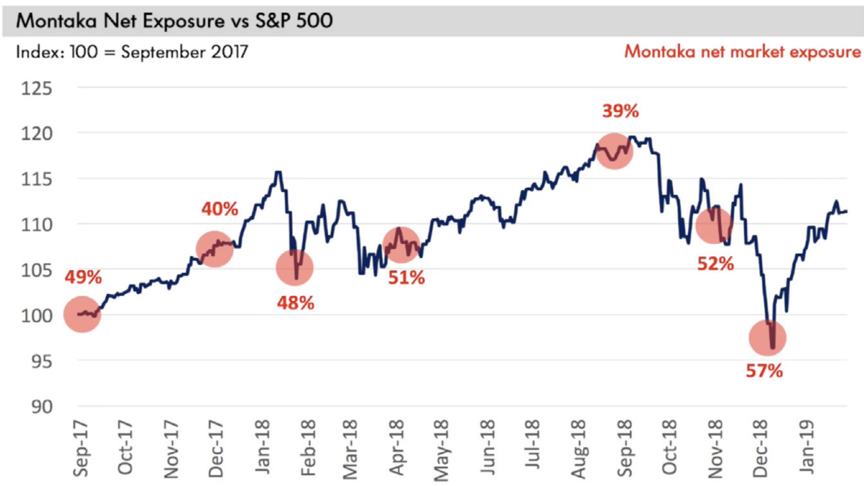
One of the most important aspects of active funds management is our ability to change the exposures in our portfolio depending on the risks and possible future rewards we see at the time.

We can increase or reduce the portfolio's exposures to particular industries at different times depending upon where we see opportunities. Similarly, we can change our geographic and currency exposures. We can also ratchet up and down our exposures to individual businesses we own.

For example, if the stock price on one of our businesses increases materially, then chances are we will trim that position unless we have learnt something new that leads us to believe the business is now worth more than we previously thought. In the same way, if that stock price declines materially, then chances are we will buy more shares at the lower price unless we have learnt something new that leads us to believe the business is now actually worth less than we previously thought.

In making these changes at the stock level, the net market exposure of our portfolio in aggregate typically increases when stock markets fall and decreases when stock markets rise. This can be a key source of value-add for our clients when performed consistently over time.

The chart here shows the net market exposure of our Montaka global equity long short strategy.



Source: Bloomberg, MGIM

Montaka's net exposure to the market is shown in the red dots over time. To give some context, I have superimposed the red dots on the S&P500 Index over the last 18 months. You can broadly when stock prices increase, Montaka's net exposure is reducing. And when stock prices decrease, such as in the final months of 2018, we were buying stocks and increasing Montaka's net exposure.

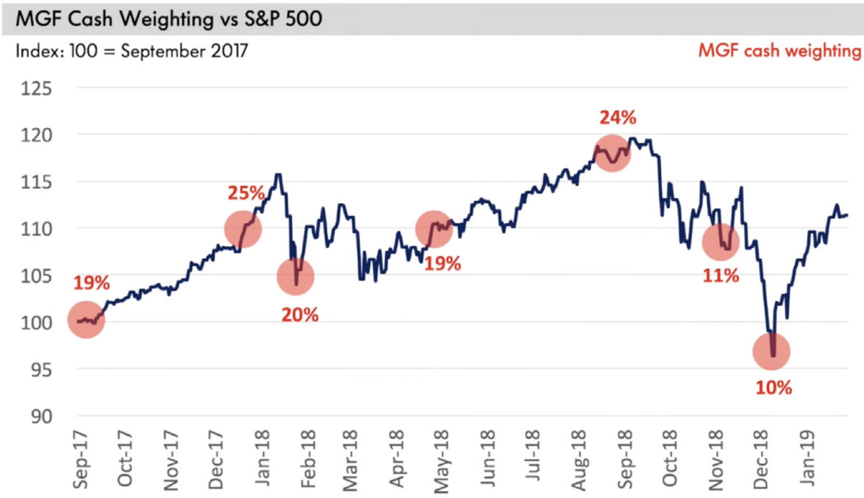
I'm sure you will agree this all looks logical – but it really is not as easy to put into practice.

To put this into effect, we have to be selling stocks when markets are rising and everyone is feeling comfortable – and inevitably we will sell too early in some cases. We are then buying stocks when prices are falling like they were in December 2018 – going against all the fear that permeated the market at the time.

But this is what our investment process leads us to do and this is why it is important to have a clear investment process that is followed with discipline through all market conditions.

Similarly, the chart below shows the cash weighting of our long-only global strategies – as represented by the Montgomery Global Fund and our ASX-quoted Montgomery Global Equities Fund, under the ticker: MOGL.

In this case you can see the cash weighting increases when stock prices rise; and then it falls when stock prices fall as we deploy the funds' cash into buying shares at cheaper prices. The concept is exactly the same as what is applied in Montaka.



Source: Bloomberg, MGIM

In closing, active management is about being active in the right places of the portfolio when it makes sense. Changes to the portfolio's exposures at different stock price levels is one of the most basic, yet important aspects of active funds management.

This article was written on 12 February 2019. All share and other prices and movements in prices are on this date.

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