CAREFULLY PREPARED BY

MONTGOMERY

BEST of the BEST

THE ONLY PRESCRIPTION FOR

HEALTHY FINANCES

ISSUE 25: AUGUST 2019

THE TWO BIG THEMES FOR AUSSIE INVESTORS

By Roger Montgomery

RISK PERCEPTION FOR THE MODERN INVESTOR

By Lachlan Mackay

DO WE VIEW BRAMBLES AS A HIGH QUALITY COMPANY?

By Andreas Lundberg

DOES CHALLENGER'S RECENT ANNOUNCEMENT IMPLY GOOD NEWS?

By Andrew Macken

MONTGOMERY GLOBAL EQUITIES FUND (MANAGED FUND)

MONTGOMERY
INVESTMENT MANAGEMENT PTY LTD

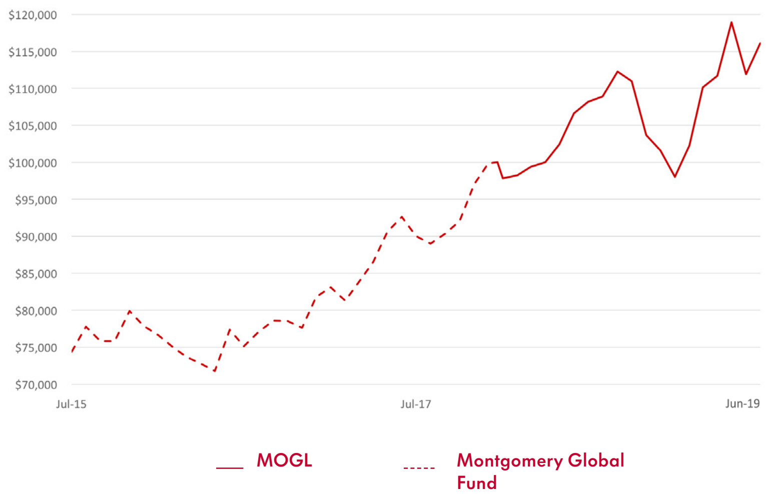
NO MINIMUM INVESTMENT

The Montgomery Global Equities Fund targets growth and regular income.

The Montgomery Global Equities Fund allows investors to earn regular income from a targeted yield of 4.5% p.a.

Here's your opportunity to invest directly in an ASX-quoted global fund – managed by the respected Montgomery team.

Performance to 30 June 2019



Performance Graph Monthly Index: $100,000 = MOGL inception (20 December 2017).
Past performance is not indicative of future performance.

To learn more about the Fund and team behind Montgomery's success, visit www.montinvest.com.

The issuer of units in Montgomery Global Equities Fund (Fund) is the Fund's responsible entity Perpetual Trust Services Limited ACN 000 142 049 (AFSL 236648). The Product Disclosure Statement (PDS) contains all of the details of the offer. Copies of the PDS are available from Montgomery Investment Management (02) 8046 5000 or at www.montinvest.com. Before making any decision to make or hold any investment in the Fund you should consider the PDS in full. The information provided does not take into account your investment objectives, financial situation or particular needs. You should consider your own investment objectives, financial situation and particular needs before acting upon any information provided and consider seeking advice from a financial advisor if necessary. You should not base an investment decision simply on past performance. Past performance is not a reliable indicator of future performance. Returns are not guaranteed and so the value of an investment may rise or fall.

FROM THE EDITOR

Welcome to our second *Best of The Best* Magazine for 2019. It is a challenging time to be a value investor in Australia. Globally, the challenge is lessened by the deep pool of opportunities but locally the relatively shallow pool is reflected in the extreme multiples investors are forced to pay for profitless companies.

Global rates are being lowered and monetary policies are set to 'stimulatory' but the reason is not a weak economy. Stimulatory settings are in place to stabilise financial markets and avoid the possibility of a market collapse fueling a recession. Add a possible resolution of the US/China trade fracas and the ingredients might be in place for rising share prices.

Domestically the economy is not strong. There is the very real risk of a deleveraging as a significant part of the workforce – residential construction workers (who make up 3.5 per cent of the workforce) – confronts the possibility of declining activity by Christmas. All of this explains why the RBA is lowering rates and suggesting they will remain low for a very long time.

Clearly, lower rates are positive for valuations and they have a more pronounced positive impact on the valuation of companies that have a large proportion of their worth in distant years.

But the reason for the rate cuts is a weaker economy and the associated pressure on the growth rates of numerous domestically-exposed sectors.

The result is rising prices at the same time as growth is under pressure. Investors are understandably bidding up assets that produce reliable income streams because the yields on offer are superior to cash and term deposit rates. Only this week I spoke with a NSW crop farmer who was has been in drought and not received farm income for four seasons. He was asking where he might find a better yield than that available from his bank.

Of course, any discussion about assets other than cash must also include the subject of risk and the chase for yield whilst ignoring risk does not usually produce pleasant outcomes.

How this tension plays out only time will tell. Experience tells me how it will probably resolve itself but neither experience nor history can tell me when.

In the meantime, it seems reasonable to expect prices and markets to remain supported. As the aphorism advises; 'don't fight the Fed'. Thankfully there are still opportunities for value investors to invest globally and while that seems to be less obvious in Australia, there will always be opportunities when businesses meet with temporary bumps in the road that are treated by the market as permanent.

Value investing is not dead but investors must be very, very patient awaiting its revival.

Roger Montgomery

Chief Investment Officer

TABLE OF CONTENTS

The two big themes for Aussie investors

Roger Montgomery, Chief Investment Officer

Roger shares his view on nine companies which are exposed to two themes that all Australian investors should watch with interest.

What do A2 Milk and Nine Entertainment have in common? They represent two key themes that Australian investors should focus on to potentially enhance their long-term returns.

These themes are: **businesses with global growth opportunities**, and **those exposed to the booming demand for software and data**.

The following companies are all growing their overseas businesses, ensuring Australian investors benefit from a growing global economy and currency diversification. Keep in mind however that getting the theme right is only half the battle. Investors must also ensure a reasonable price is paid rather than a high one.

Exposures to companies growing overseas makes sense. Over the long run, fast growth rates and long runways, particularly off a low base, can help to produce returns that defy the economic and business cycles that plague many mature businesses.

And in the short term, Australia's economy is beset by imbalances that are generating speculative misallocations of capital at one end, and pressure on sales and margins at the other.

Finally, there's a benefit that stems from having exposure to multiple geographies and currencies.

Software and data will remain a growth area for many years. From manufacturing and design to sales and marketing, there is almost no aspect of commerce that doesn't produce it, need to store or it or use it. Data, it seems, is akin to an oil discovery. And of course, software is the essential transmission mechanism for that data to communicate an intention.

TWO THEMES INVESTORS CAN FOCUS ON: BUSINESSES WITH GLOBAL GROWTH OPPORTUNITIES, AND THOSE EXPOSED TO THE BOOMING DEMAND FOR SOFTWARE AND DATA

A2 Milk (ASX:A2M)

A strong third quarter trading update from infant milk formula marketer A2 Milk revealed a 44 per cent lift in revenue. The company however announced no material changes to its full year 2019 or 2020 outlook, and this is partly due to pulling forward some fourth quarter orders.

A2M continues to grow its market share and its product lines. In China, market share now sits at 6 per cent, up from 5.4 per cent at December 2018. In the United States the company has added 300 stores to its distribution network, which included a new Costco geography. New products are also part of the growth story and after previously announcing its coffee creamer product for the US market, the company announced its Smart Nutrition fortified nutritional milk powder for kids aged between 4-12, in Australia and China initially.

Recent share price strength implies expectations of greater-than-40 per cent revenue growth and an EBITDA margin of more than 30 per cent. These are lofty numbers to deliver long term and without setback.

Macquarie Group (ASX:MQG)

Macquarie Bank's strong full year result announced in early May was driven by more volatile gains on sale and performance fees. Importantly, the international businesses now account for two-thirds of Macquarie's income. Equity capital market volumes disappointed as did foreign exchange turnover. But the company also reported higher assets under management – reaching a record half-a-trillion dollars – and mergers and acquisition activity. Coming off strong prior numbers might mean that the near-term growth outlook is more challenging, and management forecast a slightly lower profit for 2020, but what we have learned is that at this early stage of the year, management's guidance is typically conservative because it is difficult to predict revenue when so much is based on market conditions.

Macquarie trades at a premium to global investment banks but is in line with global fund managers. Investors should remember shares in the bank are 'levered' to the market. If the market falls, Macquarie could fall further.

ARB Corp (ASX:ARB)

The ARB third quarter 2019 trading update revealed 2.2 per cent Australian aftermarket sales growth. Australian aftermarket sales are 63 per cent of total sales. This was slower than the growth reported for the first half, which was up 4.1 per cent. Particularly slow were QLD and NSW. Unlike domestic sales, export sales, which represent 29 per cent of total sales, accelerated and were up 9.2 per cent year-on-year in the third quarter, compared to the 6.9 per cent growth reported in the first half of 2019. Export sales strength was attributed to the weaker Australian dollar. ARB remains one of the higher quality companies listed in Australia and management reiterated their desire to act conservatively when it comes to using their strong balance sheet for acquisitions.

CSL (ASX:CSL)

Like ARB, CSL is one of the highest quality companies listed in Australia. Management continue to see global sales, particularly in Flu Vaccines near term and in the US, as the primary source of growth. It is estimated that in the US and Europe only 30 per cent of total potential patients are receiving plasma treatment. In some part of Europe and in emerging markets immunisation rates are low, which means CSL has a long runway of growth.

CSL's growth and quality is currently fully recognised by the market and it will pay investors to wait for the company to slip, for example by failing to beat the market's lofty expectations.

Costa Group (ASX:CGC)

This berry, banana and avocado supplier owns the dominant brands in Australia and is now expanding overseas. It is also investing in research and development that reduces the seasonality in production and ultimately increases yields. Costa is looking to China and Morocco for growth. In China it has planted 110ha of berries and plans to more than double plantings to 240ha within five years. More than 25 per cent revenue growth and double-digit earnings growth is expected from China over the next three to five years. In Morocco almost 300ha of blueberries have been planted. The company hasn't completely escaped seasonality and climate and difficulties or hard times should be assessed for the temporariness.

* * *

The next group of companies are taking advantage of a booming need for technology and software.

Software is currently the sexiest place to invest for many professional investors thanks to what is being referred to as the 'digitisation of the economy' tailwind. Companies such as Afterpay, Seek, IDP Education, Wisetech Global, Jumbo Interactive and NextDC are all beneficiaries of the current popularity in software.

But while in many cases the tailwind is helping to drive revenue growth, in many cases there is limited if any profit. It's too easy to say NextDC will continue to roll out new datacentres to take advantage of the growth in data and communications, but investors must also remember that competitors will emerge, and unit prices will decline.

Low interest rates and steady economic growth however are allowing investors to defer the date that profit is delivered but eventually returns on capital need to be positive.

IDP Education (ASX:IEL)

IDP Education is benefitting from the increasing mobility of international students. Through the company's 2017 acquisition of HotCourses, the company is leveraging a platform to deliver leads, penetrate new markets and introduce its value-added services, ultimately increasing revenue. Through digitisation, such as the roll-out of its computer-based IELTS the company's already-impressive economics and margins are expected to improve. Like many companies benefitting from software tailwinds, the share price appears fully valued. In the absence of disappointment or an exogenous event, continued top line growth should remain supportive.

Nine Entertainment (ASX:NEC)

I have previously written about the structurally-shrinking audiences and profits suffered by free-to-air-television networks. Nine however is transforming itself with Stan, 9Now and Domain part of an integrated monetisation platform. Some analysts now describe Nine as an attractive growth story. The streaming service, Stan, is on an annualised revenue run rate of approximately $200 million and continues to grow subscribers.

Stan is now also profitable and is projected to incrementally add circa $30 million to EBITDA in 2020. Revenue at 9Now grew by 75 per cent – admittedly off a very low base – and the real estate portal Domain is being held up as a beneficiary of a major cross selling program within the group.

Nine recently announced the sale of its Australian Community Media and Print business to focus on its core digital strategy jettisoning 160-plus regional titles and agricultural publications as well as 130 community-based websites.

Seek (ASX:SEK)

Seek is still seen by many analysts as being tied to Australian employment cycles and while much of its profits are derived from Australia, revenue from overseas businesses is already greater. Seek however is reinvesting heavily overseas which means, at the profit level, Seek looks dependent on Australia. The reality is however vastly different and Seek continues to articulate a very long runway for growth. Price increases locally are also a strong possibility and the company believes revenue growth of circa 20 per cent out to 2025 is not unrealistic.

WiseTech Global (ASX:WTC)

While only listed for three years, Wisetech has been operating for more than two decades. The company operates in over 125 countries and is used by three quarters of the world's top third-party logistics operators and 100 per cent of the worlds freight forwarders.

After more than two decades in operation, the company grew its 1H19 revenue by almost 70 per cent and generated average revenue growth of nearly 50 per cent over the last four years. At a recent conference, the company noted that in the last six years it has witnessed less than one percent attrition for its CargoWise platform, indicating the service is entrenched into its customers systems. Forty four percent of revenue is reinvested in product development and marketing and sales, split ¾'s and ¼ respectively.

The Montgomery Fund and Montgomery Private Fund owns shares in Macquarie Group, IDP Education and Seek. This article was prepared 08 July 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 08 July 2019. All share and other prices and movements in prices are on this date.

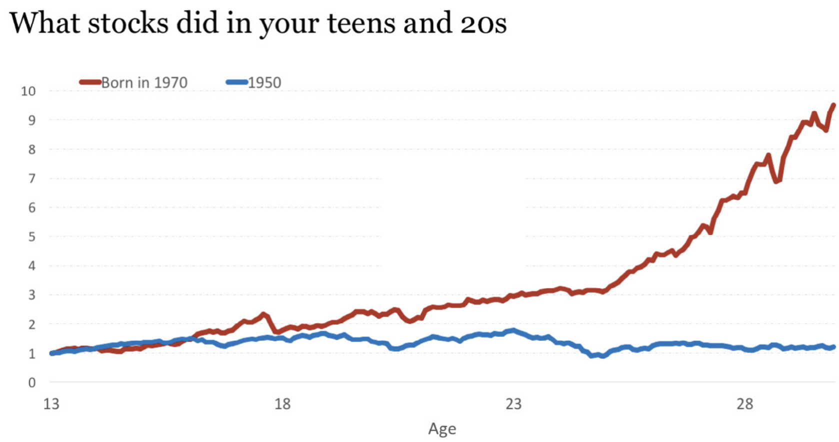
Risk perception for the modern investor

Lachlan Mackay, Research Analyst

Lachlan identifies the importance of a comprehensive risk management framework for long term investing success and shares our Montaka Fund's risk framework.

Investing is a commitment to a lifetime of learning. In an ever-evolving world, there are endless opportunities to improve your understanding of any subject. While personally I am still shifting up the gears as I move through this challenge, the most resounding message to emerge from experts such as Graham, Buffett, Munger and Marks is that a comprehensive risk management framework is fundamental to long-term success.

An individual's personal experience is granular when placed in the scheme of human history. Nonetheless, our experiences form the lens through which we each view the world. They shape our impression of events and hence anchor risk-related decisions. For instance, if you were born in the 1950s you would have had a vastly different worldview to someone born in 1970. Your most impressionable years were spent learning from a risk averse generation operating in the wake of the Great Depression. High growth opportunities were scarce; the stock market was flat. By contrast, those born in 1970 saw ever expanding opportunities through to the dot-com boom of the late 1990s. The stock market grew 10-fold as those embracing new technology with new inventions were rewarded for taking risks.



Source: The Collaborative Fund

My experience has seen the world evolve from a cautious population licking their wounds post-recession to a burgeoning tech environment where profitless venture-backed startups are consistently valued above $1 billion. The entrepreneurial culture of growing US cities, and especially college towns such as Berkeley or Stanford, attracts the brightest young minds looking to take advantage of the growing pool of resources. More vision funds have increasingly more venture capital to give to anyone who believes they have the next great idea.

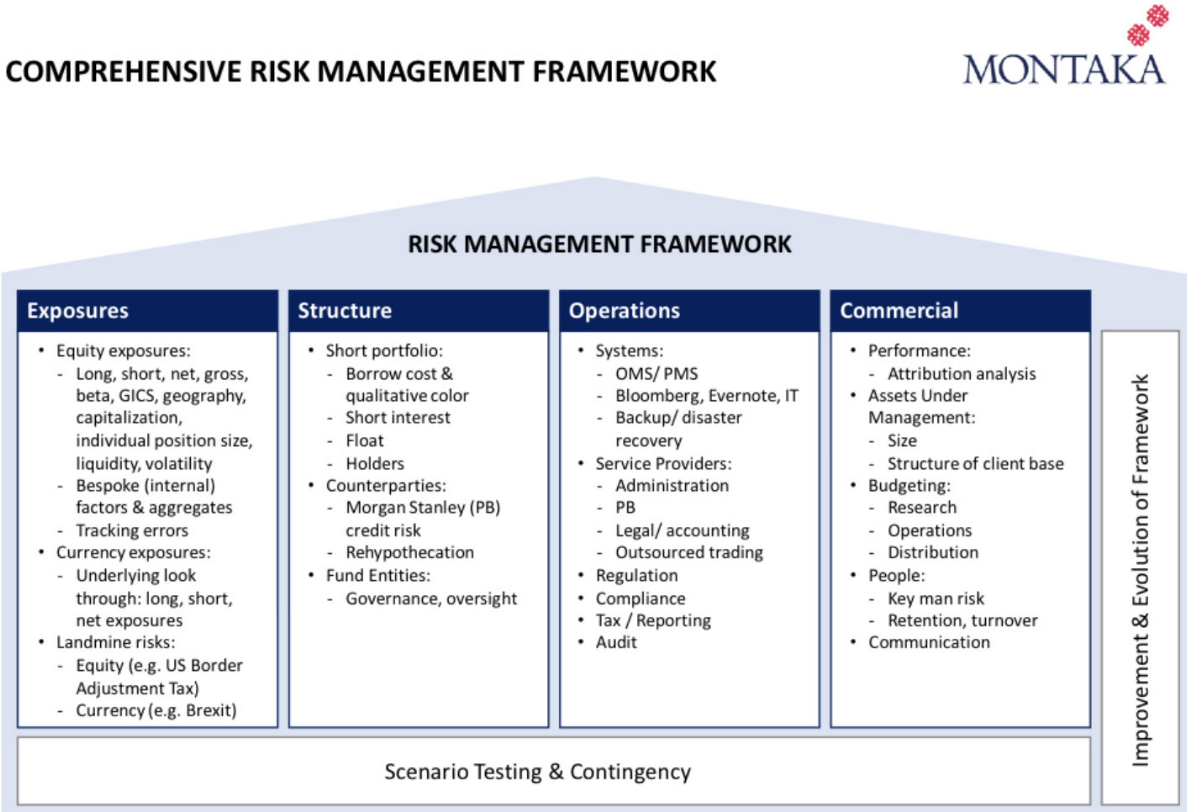
Venture capital investment relies as much on intuition and experience as it does on known information and concrete fact. Whilst their businesses appear innovative and attractive, these start-ups often fail. Most do not even get funded.

According to a Harvard Business School study by Shikhar Ghosh, 75 per cent of million-dollar venture-backed start-ups are bankrupt before returning any money to investors. Exciting new ideas certainly do not guarantee the next Uber or Amazon.

As such, venture capital's ongoing success should raise some red flags, especially now that it is being exposed to public markets. A commonly fatal misperception among investors is the situation where favourable conditions allow a bad process to produce a good outcome. The last 5-10 years have been some of the best in history to invent something new and disruptive – more openings, lower barriers, better returns, greater upside. Less perceived risk.

If the investing greats of history have taught me anything so far, it's that this is unsustainable. As market prices rise higher, more capital is invested with lower margins of safety, in turn spent by highly leveraged businesses who promise to return it with interest. The longer these positive conditions persist, the more investors will be willing to ignore the potential for Black Swan events such as the Global Financial Crisis.

We consider risk management to be not only the most important feature of our investment philosophy, but also our greatest strength. Our Montaka Funds' framework incorporates a vast range of exposures in a naturally risk-averse long-short structure. Along each risk dimension we consider the consequences of every potential scenario, and then take proactive mitigating action to insure against any unacceptable externalities. Moreover, we use our flexibility to adjust our net exposure to reflect the risk environment we face in any given period.



Source: Montaka Global Investments

Although the investment business will continue to evolve through generations, the risk-averse philosophy of old will always ring true. We work to emulate the greats before us through our comprehensive risk-conscious approach to capital management.

This article was written on 27 June 2019. All share and other prices and movements in prices are on this date.

Does Challenger's recent announcement imply good news?

Andrew Macken, Portfolio Manager

When Challenger's CEO recently announced he was abandoning the group's return-on-equity target, the market did not take kindly wiping off 16 per cent of Challenger's market cap over 24 hours. Andrew asks if this news was hiding something good for the company's future?

At an investor day in Sydney on 13 June, newly-appointed CEO of Challenger (ASX: CGF), Richard Howes, announced something that any new CEO would rather not. Howes announced that he was abandoning the 18 per cent pre-tax Group normalised return-on-equity (ROE) target that had been held by the company for the last 15 years. The market did not take kindly to this news, wiping off 16 per cent of Challenger's market capitalisation over the subsequent 24 hours.

But it is worth digging into this change made by Challenger's management team more deeply. You see, Howes did not simply abandon the prior 18 per cent ROE target; he instead replaced it with a formulaic target that incorporates the RBA cash rate. That is, Challenger now targets a Group normalised ROE of the RBA cash rate plus 14 per cent, pre-tax. Said another way, if the RBA cash rate is high, for example at 5.25 per cent in 2004 when Challenger's original 18 per cent ROE target was set, then Challenger's new ROE target would be 19.25 per cent. Whereas, if the RBA cash rate is relatively low, for example at 1.00 per cent today, then Challenger's new ROE target is 15.00 per cent.

Given the nature of Challenger's business, this new formulaic structure for the ROE target of the business is reasonable. After all, the earnings generated by Challenger's life business – which drives the vast majority of the company's total earnings – is derived from two broad components: (i) the interest earned on the shareholder capital that is required by regulators to be held; and (ii) the spreads, or risk premia, that can be harvested by the company on its book of life business. In a low interest rate world, the former will obviously be lower – and sometimes the latter too.

Of course, lower earnings are generally considered to be a bad thing by investors, all else being equal. But all else is not equal. You see, if earnings are lower only because interest rates are lower, then it also implies that an investor's opportunity cost is also lower. This is a concept in finance theory that basically compares the ROE that is generated by a business to an investor's best alternative return that could be generated by taking the same degree of systematic risk. This opportunity cost is often referred to as the "cost of equity" in the industry jargon.

Here is how to think about it. If Challenger's cost of equity is, say 10.5 per cent, and it generates an ROE of, say, 14 per cent, then it has created value. If it generates an ROE of 10.5 per cent, then it has neither created nor destroyed value. And if it generates an ROE of less than 10.5 per cent, then it has destroyed valued.

When Challenger announced a lower ROE target, the stock price reaction arguably implied that the reduction in ROE was not accompanied by a commensurate reduction in the firm's cost of equity. This cannot be true. The company's cost of equity must be lower as the RBA cash rate falls. And a lower cost of equity, said another way, equates to a higher fair price-to-earnings multiple, all else equal.

At Challenger's investor day, Richard Howes categorically stated that he believes the business will generate an ROE well above the company's cost of equity. And here is where the finance theory gets really interesting. If a business can generate the same excess return over and above its cost of equity under all conditions, then this business should actually be more valuable in a world in which the cost of equity is lower, notwithstanding the lower company earnings. Food for thought.

The Montgomery Global Fund and Montaka own shares in Challenger. This article was prepared 18 July 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 18 July 2019. All share and other prices and movements in prices are on this date.

Do we view Brambles as a high quality company?

Andreas Lundberg, Joint Portfolio Manager

Andreas shares the eleven different categories we use to evaluate a company and applies this framework to Brambles.

Brambles is one of the companies that you'd think would tick quite a few of the quality criteria that Montgomery use to evaluate any potential investment opportunity.

When evaluating the quality of a company, we assign a score between minus two and plus two (although we call the scores weak, below average, average, above average and superior) on eleven different categories. This is then combined into an average score that ranges between minus two (weak on all categories) and plus two (superior on all categories). As a general rule, we do not invest in any company that has a score below zero (average quality) and the closer to zero the score is, the more compelling the valuation has to be.

The core is initially proposed by the person on the team responsible for analysing a company and then debated with the rest of the team to make sure that we calibrate the score to the overall market and not just to the particular persons reference frame.

Today, I will use Brambles (ASX:BXB) as an example to show the different criteria we use to define quality.

For people who are not familiar with Brambles, they are the worlds biggest provider of closed loop pallet services. What this means is that they provide the wooden pallets that companies use to stack their goods on for transport.

What closed loop means is that Brambles own the pallets and pick them up and reuse them when the customer is finished with a particular transportation. The alternative is an open system where a company instead buys a pallet and then scrap or re-use it themselves when they are finished with it. By reusing the pallets and using the pallets for many different customers, Brambles is able to offer its customers a cheaper solution than buying their own pallets.

Brambles is a substantial company listed on the ASX with a market capitalisation of close to $20 billion.

The picture below is a screenshot of the tool that we have developed in-house to keep track of the quality scores we assign to companies.

Source: MIM

Let's run through the criteria:

1. **Pricing power** – Pricing power is generally a very good thing to have as increased prices directly impact the profit line and it also indicates that the company are providing true value-added products/services that are essential to the customer. We rate Brambles as **Average** on this criterion as there is some evidence that they are able to increase prices above inflation currently, but we also acknowledge that customers always have the option to buying their own pallets if Brambles are too aggressive in their pricing.
2. **Barriers to entry** – High barrier to entry in an industry is good for the incumbents as this should enable the conditions to make good returns. We rate Brambles as **Above Average** on this criteria as although it is very easy to start manufacturing of pallets, it would take very substantial capital to build up enough volumes and the logistical network needed to be able to compete and offer a price that is comparable to what Brambles and other incumbents are able to.
3. **Industry structure** – Generally, a concentrated industry with few players is easier to make high margins in than a very competitive industry with a lot of players. We give an **Above Average** rating here as there are not many players competing in the closed loop pallets business (generally 3-4 in each part of the world).
4. **Customer stickiness** – It is generally good for a company if it is very hard for its customers to switch to a competing product. For Brambles, we rate this criterion as **Below Average** as pallets are a commodity and as long as the supplier can supply enough volume, it is not at all hard to switch.
5. **Reliability of demand** – Having very reliable demand allows a company to plan longer term and lowers the risk for surprises which is something that the stock market generally does not like. We rate Brambles as **Average** as they are very much at the mercy of their customers which are primarily fast-moving consumer goods, food, beverage and general manufacturing companies which should be relatively stable but are still dependent on overall economic activity.
6. **Growth potential** – Strong growth potential is of course better than a stagnant industry. We rate Brambles as **Average** here as the closed loop industry should be able to grow its market share from pallet manufacturers selling pallets directly to customers over time, but demand is still tied closely to general GDP growth.
7. **Power vs. suppliers** – It is good to have powers vs. your supplier to ensure that you are the one capturing the majority of the economic benefits in the value chain. We rate Brambles as **Above Average** on this as there are plenty of suppliers of wood and it is a very standardised material so Brambles should be able to play its suppliers off against each other.

8. **Disruption risk** – Being disrupted by technological innovation is not a good thing (ask Kodak!). It is hard to see any real alternatives to wooden pallets any time soon and Brambles would easily be able to include any new types of pallets in their system as their main skill is logistics and not pallet manufacturing per se. The reason we assign an **Average** rating is because there is some risk that changing the type of manufacturing, like for example 3D printing could impact the transportation needs for some of Brambles customers (although we admit that there is probably upside to this rating).
9. **Company position** – Being the market leader is generally a good thing, especially in an industry where there are economies of scale as this should ensure that you produce higher profits that you can use to re-invest and further grow your competitive advantage. We rate Brambles as **Above Average** as they are the clear market leader globally and also in each part of the world, but they still have some competition with 2-3 competitors in each market.
10. **Capital intensity/ROIC** – We generally like companies with low capital intensity as that makes it easier to produce high returns in the capital invested in the business. It also lowers the risk of assets becoming obsolete due to changes in the industry. We rate Brambles as **Above Average** here as although they do own over 600 million pallets, they are able to make a relatively high return on invested capital (ROIC) of around 15 per cent as the main value in the business is not the pallets themselves but the logistics system and the network effects that enables a high utilisation of the pallets.
11. **Other/not covered** – This is a criterion that we reserve in case there is some special aspect of the business that is not covered by any of the other criteria. For Brambles, we have not been able to identify any and hence the **Average** rating.

Taking this all together, we arrive at a quality score of 0.36 indicating that based on our view Brambles quality is quite a bit higher than the average Australian company.

So, the question then arises, why is Brambles not owned by The Montgomery Fund? The reason is that the quality assessment is only one of the inputs that determine if a company is an attractive investment opportunity. At the moment, our assessment of the valuation that the market is applying to Brambles makes it less attractive than some other opportunities of the same or higher quality and hence it is not included in the portfolio at this point in time.

This article was written on 2 May 2019. All share and other prices and movements in prices are on this date.

IMPORTANT NOTICE

For more information on investing with Montgomery, please contact Dean Curnow on 02 8046 5000, or email him at dcurnow@montinvest.com.

MONTGOMERY