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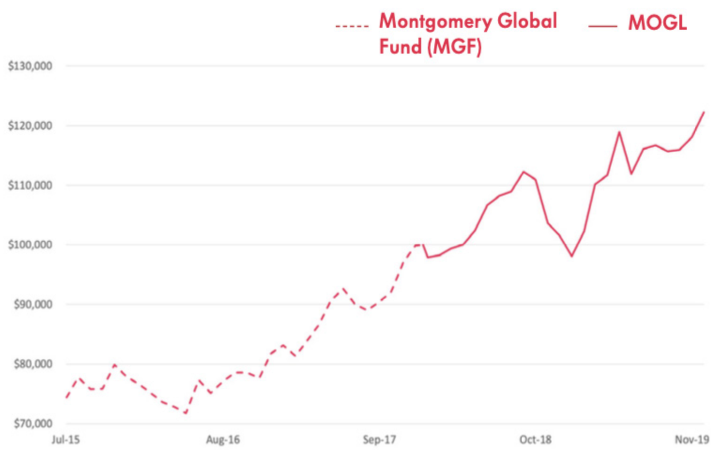

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FROM THE EDITOR

Welcome to the final edition of *Best of the Best* for 2019.

There's a tension in markets between bulls and bears, and the fact that the bullish investor is winning is a reminder that it pays to be an optimist.

As we noted a few months ago, the dangerous impulsivity then evident in both private equity markets and parts of the bond market suggested a boom had morphed into a definable bubble. Since then, office sub-leasing company WeWork's IPO has been pulled and many of the extreme valuations being touted for unicorns have also pulled back as we expected them to.

When WeWork's private equity market valuation exceeded that of the landlords from who it was leasing space, it became obvious some had lost their marbles.

Over in the bond market, we also alerted investors at the time to the fact that US$17 trillion of sovereign bonds issued by countries including Switzerland, Japan, Germany and the Netherlands, or about 20 per cent of global GDP, were trading with negative yields. Given that a bond can only ever return the face value of the bond and the remaining coupon/interest payments, a negative trading yield meant buyers were paying a higher price than the combined face value and remaining coupons. In other words, they are guaranteed to lose money if they hold to maturity. It was enough to trigger the Bank of International Settlements, in the context of observing that monetary policy will become ineffective "should a downturn materialize" to note; "there is something vaguely troubling when the unthinkable becomes routine".

Since then, the quantum of bonds trading with negative yields has declined. In other words, bond prices have pulled back. But the pull backs in both Private Equity valuations and the volume of negative yielding bonds have occurred without disrupting equity markets, which have again soared to new highs.

It pays to be an optimist.

In the context of what might be generally described as expensive markets, there also appears to be value around. We note The Montgomery Fund and The Montgomery [Private] Fund have served investors well buying Telstra below $3.00 this year, buying Navitas and TradeMe, which both received takeovers, and buying IDP Education.

And in the Montgomery Small Companies Fund, investors have benefitted from investments in under-the-radar companies like PointsBet which has risen as much as 48 per cent since we launched the Montgomery Small Companies Fund.

Many investors are nervous about the extended valuations of the major indices, about negative yielding bonds, Brexit, Trade Wars and even the impeachment machinations on next year's US elections, but in the very long run, buying high quality businesses when individual valuations are attractive should work out ok. Sure, there'll be volatility along the way and those investors less optimistic can consider the less-widely-covered smaller companies Gary and Dominic focus on here at the Montgomery Small Companies Fund, or the capital preservation goals embedded in The Montgomery Fund and The Montgomery [Private] Fund. But whichever way you go, have a very long-time horizon and remain optimistic.

Roger Montgomery

Chief Investment Officer

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Roger Montgomery, Chief Investment Officer

Bulls, bonds and brain damage

Roger discusses the insanity being displayed and investors could do worse than rebalancing portfolios by reducing weights to these classes.

There's a dangerous impulsivity evident in both private equity markets and parts of the bond market that suggests a boom has morphed into a definable bubble. Whether it is from these markets that the next black swan or contagion emerges remains to be seen but bubbles they are, without doubt. In the first instance investors could do worse than rebalancing portfolios by reducing weights to these classes.

When the unthinkable become routine

Persistent negative yields on a growing quantum of sovereign bonds has captured the financial media's attention. Today, US$17 trillion of sovereign bonds, or about 20 per cent of global GDP, are trading with negative yields. Bonds issued by countries including Switzerland, Japan, Germany and the Netherlands now have negative yields and even dodgier credits such as Italy have negative shorter-term rates.

It has been enough to cause the central banks' banker, the Bank of International Settlements, in the context of observing that monetary policy will become ineffective "should a downturn materialize" to note, "there is something vaguely troubling when the unthinkable becomes routine".

Vaguely troubling is putting it lightly when one looks at junk-rated corporate bonds trading at negative yields. Yes, you read that correctly. A bond buyer who holds to maturity can only receive the face value of the bond and the coupon or interest payments. If the premium they pay above face value is greater than the sum of the remaining interest payments, they are locking in a loss.

Of course, if the issued bond is CCC-rated, there is the real prospect that the issuer defaults on their obligation to repay the face value. Typically, this not insubstantial risk is compensated for through a higher yield.

VAGUELY TROUBLING IS PUTTING IT LIGHTLY WHEN ONE LOOKS AT JUNK-RATED CORPORATE BONDS TRADING AT NEGATIVE YIELDS.

So the buyer of a negative-yielding corporate bond will lose money by holding to maturity and could also lose money if the company defaults. Investors surely cannot be that irrational.

Something else is going on

What is going on is pure unadulterated speculation. The buyer of a negative-yielding bond is simply hoping that rates head even more negative. The only way that can happen is if a bigger 'fool' pays a higher price for the bond and accepts an even greater negative yield.

Nobody wants to hold these bonds to maturity, and the buyer is obviously not expecting the company to default while they own the bond. Everyone trading these securities must therefore be expecting to have one last dance before the barn burns down. They're expecting to be able to get out safely before they're consumed.

Of course, now that these bonds are already negative yielding, someone has to lose, therefore some will. Whether or not it's brain malfunctioning, consensual hallucination or an intellectual short-circuit, it is rebadging speculation as investing.

So far of course, everyone who bought these bonds at higher yields has done well. In Europe, for example, according to the ICE BofAML Euro High Yield Index, the average yield on junk bonds is less than 2.90 per cent. Anyone who purchased corporate high yield junk bonds back in 2012 when the index yield was at over 11 per cent or in 2016 when the yield was above 6 per cent has made a fortune.

CASH MAY ONLY OFFER A PERCENT OR TWO BUT THAT'S BETTER THAN MINUS 50 PER CENT.

To crystalise the profit, however, the owner has to sell and the new buyer must clearly believe yields will even be lower and more negative in the future so they can, in turn, sell to a similarly brain-dead or testosterone-fueled individual or institution.

European corporate bonds trading at negative yields this year include those issued by Ardagh Packaging Finance plc, Altice Luxembourg SA, Altice France SA, Axalta Coating Systems LLC, Constellium NV, Arena Luxembourg Finance Sarl, EC Finance Plc, Nexi Capital SpA, Nokia Corp., LSF10 Wolverine Investments SCA, Smurfit Kappa Acquisitions ULC, OI European Group BV, Becton Dickinson Euro Finance Sarl and WMG Acquisition Corp.

Elsewhere, it's the terms of the bond that produces a negative expectancy. By way of example, earlier this month, the owner of the Tinder dating website, Match Group Inc. saw its 6.375 per cent unsecured note trading at 105.35 cents on the dollar.

If these bonds were held to maturity in 2024, they would yield approximately 5 per cent but the yield achieved on these bonds could be much lower because the bonds became callable in June of this year. In other words, at any time, Match can redeem the bonds by paying investors a modest premium over face value. If Match took advantage of today's speculative frenzy to refinance the bonds, the actual yield would be minus 0.20 per cent. For an online dating site!

Private equity values will come back to bite

The insanity being displayed among negative-yielding, high-yield bond traders is also evident among private equity and venture capital punters.

That Uber even exists is a function of equally brain-damaged altruists. Evidence that its model is broken is the popularity being driven by an underpricing its main service. There is a negative return on its investment in technology and a negative return to its owners. Uber won't exist in its current form in a decade.

You can predict a similar outcome for Tesla thanks to Porsche, Mercedes, Audi and VW's announcement of production-ready electric vehicles at this year's international motor shows. Tesla will be forced to cut prices in an attempt to maintain volume and losses will accelerate.

Then there's Peloton, a company selling US$3,000 stationary training bikes with a US$39 monthly subscription to an app that links you to your favourite spin class. Think Ab Blaster or thigh master meets Jane Fonda on roller blades with a Nintendo Wii Fit in her hand. It's a fitness fad whose offer will be on the council collection heap in years to come, seeking a US$8 billion valuation.

Fortunately, the more recent cancellation of the WeWork IPO – US$5 million paid to the founder for the right to use the word 'We' anyone (?) – is evidence that the bubble may have been popped.

History is replete with examples of investors losing their minds and believing the unsustainable is permanent. How it plays out is anyone's guess but serious investors should look elsewhere. Cash may only offer a percent or two but that's better than minus 50 per cent. It all reminds me of Herb Stein's quote: "If something cannot go on forever, it must stop."

This article was written on 09 October 2019. All share and other prices and movements in prices are on this date.

Why valuation still matters

Joseph Kim, Senior Analyst

Joseph identifies why valuation overlays help to provide an anchor for when a share price may suggest good "value" to the incremental investor.

There has been a lot written about the death of value investing, and how growth investing has outperformed significantly over recent years. However, it is important to distinguish the difference between the traditional concepts of "value" investing – i.e. capital intensive industries trading at low price-earnings or other similar ratios (including price / book), with the concept of "valuation" – determining the present value of an asset.

The concept of valuation is subjective to the valuer, but it transcends all form of investing. In its purest sense, value is reflected in the last transacted price, as it reflects the middle ground between a willing buyer and a willing seller at that point in time. As an individual, you may not agree with the price, but there may be someone out there who is willing to take a different view – this is what makes the market.

However, there are times when the last transacted price may not be a meaningful reference point to determine a future value outcome despite the human tendency to do so – a potential form of anchoring bias. The example of Pro Medicus (PME:ASX) is a useful case study to illustrate when the concept of valuation – rather than price – becomes important.

PME's share price performance

PME has been one of the top performers on the ASX300 this year, with the share price peaking at $38/share, good for a 218 per cent increase over the past 12 months. However, the stock was one of the worst performers in September 2019, with the share price around $29/share equating to a 24 per cent fall from its recent highs. The fall was for the most part triggered by a small sell-down of shares by the founders (around 2 per cent of shares on issue).

Pro Medicus share price performance

Source: Bloomberg

Given the share price fall, does this suggest PME is now good "value"? Using the recent highs as a guide – the shares are 24 per cent "cheaper"– and the fact there's been no major change to underlying business fundamentals, would suggest a closer look is warranted.

However, instead of looking at where it has come from, it is important to ask was that the "right" share price in the first place. A share price fall may trigger initial interest, but having a valuation overlay helps put price moves in context.

When valuation matters

Valuation overlays help to provide an anchor for when a share price may suggest good "value" to the incremental investor, given a certain set of projections. i.e. would the buyer expect to reliably make a profit from acquiring shares at the prevailing price regardless of investing strategy – whether it be earnings growth, company re-rate, price momentum, greater fool theory, or any other method. Note how this is completely independent to the concept of being a growth or value investor.

This anchor applies for any sort of valuation methodology – whether it be revenue or earnings multiples, balance sheet ratios (price / book) or discounted cash-flow analysis. While subjective, it is these valuation metrics that help determine your view of a "floor" price on a given set of assumptions.

Despite having a superior product to competitors, the concept of valuation is separate to the perceived quality of a business. At a forecast PE of 119x for 2020, and given the size and nature of PME's contracts, it would have likely taken a number of years before the projected growth of PME's earnings could justify the prevailing valuation metrics for the majority of investors.

Potential to forgo gains, but process is important

The potential downside to this argument is that strict adherence to these philosophies may result in taking profits early – in this case, one could make a reasonable argument about PME's stretched valuation metrics at $25/share based on the projected level of earnings growth.

However, these same stretched metrics would have only gotten more stretched at $30/share, $35/share, and eventually $38/share, so selling at $25/share would have resulted in forgoing 50 per cent of the upside.

One exercise that may help mitigate sellers' remorse is to back-solve the revenue and earnings growth projections that are implied in the share price – compared to your projections – through a relative value lens, to determine whether the assumptions may appear reasonable to the incremental investor.

While this process may inevitably lead to taking profits earlier than what hindsight will determine, this discipline should help limit the downside as a result of an unexpected change in market sentiment to the shares.

This article was written on 04 October 2019. All share and other prices and movements in prices are on this date.

The power of compounding when rates are low

Andrew Macken, Portfolio Manager

Should global interest rates remain lower for longer, there are significant implications for asset prices – including for equities. Andrew identifies two ways to argue the effect of low rates on equities.

The new low interest rate world in which we find ourselves is strange. Why does it make sense that an investor should have to pay for the privilege of lending to the German government for 20 years, for example? And yet, the yield on German 20 year bunds is negative – effectively implying exactly this.

There are many reasons why interest rates are low. These include: ageing populations all around the world; very high indebtedness by many corporates and governments; an increasing dominance of technology which is relatively less labor and capital intensive; and an increasingly globalised world connected by US dollar-denominated trade – which, as it turns out, also contributes to the wave of global disinflation which is keeping rates low.

Should global interest rates remain lower for longer, there are significant implications for asset prices – including for equities. There are two ways to argue the effect of low rates on equities.

First, the bear case, which goes something like this. Interest rates are low because global economic growth is slowing. Slower growth naturally feeds into slower growing revenues for corporates, which slows the rate of earnings growth. Slower earnings growth should, in turn, result in lower valuation multiples. Therefore, this new world signals downside risk in equity prices.

Now here is the bull case. In a protracted lower interest rate environment, the implied "hurdle rate" of return demanded by equity investors may decrease. The logic here would be that, even while preserving the premium over the risk-free rate of return that equity investors demand for taking equity risk; the fact that global risk-free rates have largely stepped down should, in turn, result in an equivalent step down in the hurdle rate of return required by equity investors. Now, all else being equal, for the implied hurdle rate to reduce, equity prices must increase.

We have seen this latter dynamic in bond prices over the last 12 to 18 months. As interest rates have fallen, bond prices have delivered very strong double-digit capital gains. Equities should be no different – and indeed, higher-growth earnings streams should be even more sensitive to reductions in hurdle rates, than lower growth earnings streams.

One logical investment approach in such a new lower-for-longer interest rate environment would be to buy earnings streams which are growing sustainably. That is, earnings growth which should materialise under nearly all economic environments that play out. Take the French company Vivendi, for example. It owns the largest record label in the world: Universal Music Group (UMG). UMG earns a royalty from subscription fees paid by consumers to music streaming platforms, such as Apple Music, Spotify and others. Therefore, as more consumers adopt digital music streaming all around the world, UMG's revenues and earnings grow. And this dynamic is structural with a long runway still ahead. Consider that only around 13 per cent of adults in the US subscribe to a paid digital streaming service. In countries like France, Germany and the UK today, this penetration rate is less than 10 per cent. And in in China today it's around 1 per cent. These low penetration rates underwrite structural growth in global digital streaming revenues of around 20 per cent per annum, well into the next decade.

In a low interest rate world, growth becomes increasingly valuable to investors. But what drives rates low in the first instance, is tied to lower economic growth. Therefore, as bears will argue, low rates are a warning sign for equities. But a strategy which focuses on owning earnings streams which are growing sustainably, should benefit from the magnification in value of the growth, without the risk of the growth becoming impaired.

This article was written on 04 November 2019. All share and other prices and movements in prices are on this date.

The Montgomery Global Funds and Montaka own shares in Vivendi.

The anatomy of the Australian small cap market

Gary Rollo, Portfolio Manager

Gary shares the four segments we use to classify the small-cap universe - Growth, Cyclical, Resources or Stable Compounders.

We like small companies with strong growth potential, especially if they are relatively undiscovered. In this article, we share the four segments we use to classify the small-cap universe.

The Montgomery Small Companies Fund has the Australian Small Ordinaries Accumulation Index as its benchmark, and currently this represents companies ranked 101 to 295 in S&P's index size ranking system.

Companies in this index (and other companies) that sit outside the ASX100, or those listed on the NZX, represent the opportunity set for our new fund. It is worth comparing some investment statistics for the companies that make up the ASX100 (Big) and the Small Ordinaries (Small), and this highlights some key facts:

	Big	Small
Growth	0.3%	13.2%
Yield	4.8%	3.0%
PE	18.8	17.0
Brokers	12	6

Source: Factset, Growth = 1 year consensus EPS growth rate forecast, Yield = Trailing Dividend, PE= 1 year forward Price to Earnings multiple, Brokers = number of publishing analysts

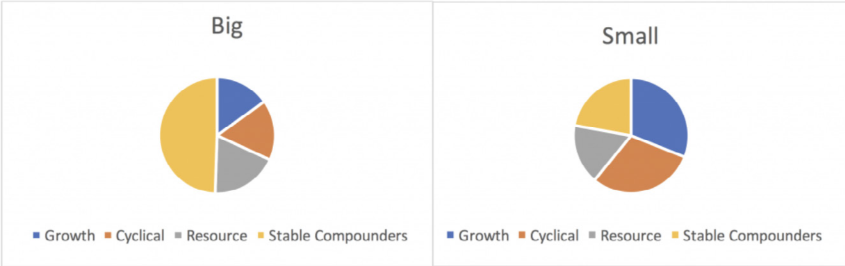
Some key observations:

- Small companies are growing much faster, while yielding modestly less. This makes sense as companies at an earlier stage of their lifecycle have greater scope to grow generally requiring internally generated capital. By comparison to relatively mature businesses which tend to populate the ASX100.
- Small companies are around 10 per cent cheaper based on the prospective PE. The materially stronger growth profile does compensate with their higher risk attributes.
- With the average small company having 6 brokers covering it, rather than the 12 in ASX-100, there are often opportunities yet to be fully discovered. The broker coverage drops considerably as you go down the size spectrum.

Segmenting investments

We classify all investment options into four segments – Growth, Cyclical, Resources or Stable Compounders.

Comparing the Big Cap and Small Cap Index constituents in our segmentation explains why the material divergence in growth exists. It's structural. The "Growth" segment represents 30 per cent of the Small Caps index compared with 15 per cent in the Big Caps index.



Source: Montgomery

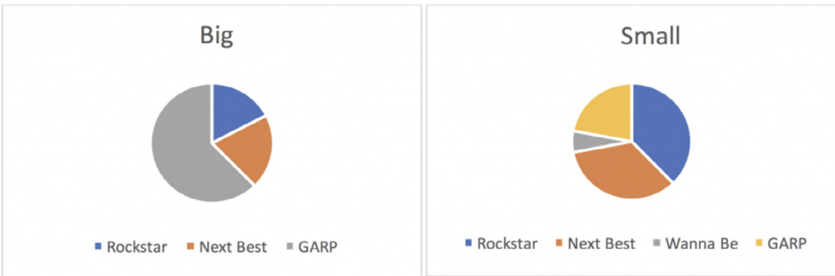
And this helps to explain a lot of the growth divergence – the gap between 0.3 per cent for the Big Caps and 13.2 per cent for the Small Caps is detailed in the table on the previous page.

Small Cap growth quality – it's where Rockstar's become famous

At Montgomery Lucent, Dominic and I know that not all growth companies are created equal, especially in the eyes of investors looking to value their businesses. What is important is the quality of that growth.

We classify our growth options as follows:

- Rockstars – companies that have a proven competitive position addressing a large market with the potential to scale and deliver strong earnings growth for years to come.
- Next Best – companies that are currently growing fast at 12 per cent per annum over the ensuing two years.* They have a competitive offering, with scope for strong growth but not in the dominating fashion expected of the Rockstar cohort.
- Wanna Be's (and Never Gonna's) – are unproven in terms of their competitive position and with the potential to address a large market and become tomorrow's Rockstar. However, many Wanna Be's become Never Gonna's.
- GARP – Competitively positioned companies which enjoy visible but lower and steadier growth (single digit), due to the more mature aspects of their businesses.



*Source: Montgomery, * = Next Best growth hurdle 12% for Small Caps, I've used 10% for Bigs…*

The Rockstars account for 40 per cent of the growth small companies

Rockstars account for 40 per cent of the growth segment for small companies. These are tomorrow's leaders – they have two-year EBITDA growth exceeding 25 per cent annualised growth; and that is good growth. And there is good provenance here; just look at those former Rockstars which have recently migrated to the ASX100 – Xero (ASX:XRO), Wise Tech Global (ASX:WTC), Afterpay Touch Group (ASX:APT), A2 Milk Company (ASX: A2M) and Altium (ASX:ALU).

And many of these companies are taking advantage of the way the technology landscape has changed, utilising cloud-based technologies to challenge bigger incumbent competitors and win.

I have previously shared some insight on the technology advantage for small companies, see my previous article.

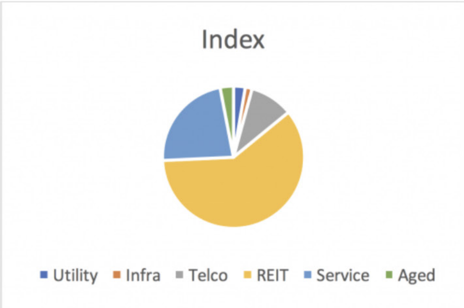
We expect the market to offer a regular stream of these types of opportunities. We see some now, while others are currently classified as Wanna Be's. We focus on trying to ascertain which of the Wanna Be's will transform into Rockstars, and which will be demoted to Never Gonna's. Our ten plus years' experience and process give Dominic and I the confidence to discern between Rockstars and Never Gonna's relatively early in the company's life cycle.

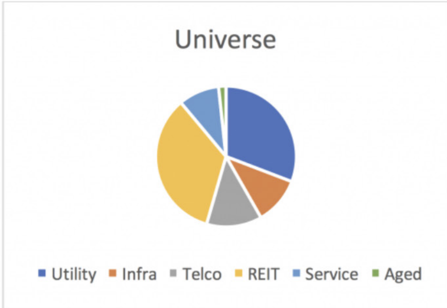
While there are 57 companies in the Small Cap Index we classify as "Growth," we look beyond the index for undiscovered growth stocks. For example, we are currently tracking another 64 companies we classify as "Growth", demonstrating there are plenty of opportunities for us to find tomorrow's leaders today. We use our lifecycle investing approach – see Dominic's article on how we think – to gain access to a select group of earlier stage growth companies, whilst strictly managing risk, which we believe could have the potential to deliver excellent investment returns over the longer term.

Finding differentiated Stable Compounders

We believe "Stable Compounders" are under appreciated by the market. A Stable Compounder is high quality, has a good competitive position and a strong management team capable of delivering a sensible strategy. These companies are typically at the cashflow harvesting stage of their lifecycle. The underlying businesses might offer limited growth, with good yield, and provide some ballast for the portfolio.

Readers should be aware the index presents some concentration risk in that 60 per cent of the Stable Compounder cohort comprises REIT's, which generally march to the same valuation drivers. While we invest in Stable Compounders, our investment horizon includes a broader universe of companies, such as stocks listed in New Zealand (but those outside the ASX100), and the various sectors are illustrated in the graph below.





Source: Montgomery

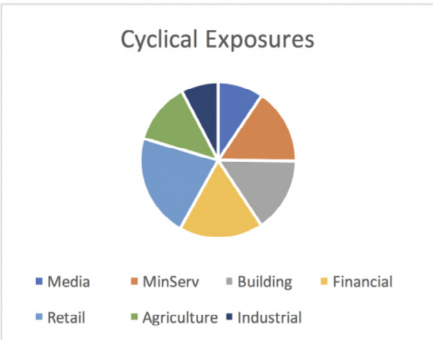
By taking a broader approach, we reduce the concentration risk within the dominant REIT group in the index. We gain diversification, liquidity, breadth and a modestly improved growth rate, whilst dropping little in yield.

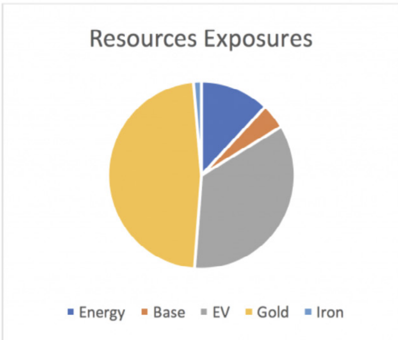
	Index	Universe
Yield	3.6%	3.5%
Growth	4.8%	5.4%
Capitalisation ($m)	69,512	105,919
# of stocks	35	47

Source: Factset, consensus data

Finding opportunities in the cycle – Cyclicals and Resources

With Industrial Cyclicals (30 per cent) and Resources (17 per cent) representing 47 per cent of the Index, we have the opportunity to find numerous cyclicals and/or commodity-related situations we like. We are happy to invest in cyclical companies when industry tailwinds or company specific situations present an opportunity. We have a lot of choice as to which "cycle" we invest in at any time.





Source: Montgomery

Industrials	30.0%
Media	2.8%
Mining Services	4.7%
Building	4.6%
Financials	5.2%
Retail	6.4%
Agriculture & Food	3.8%
Industrial	2.3%
Resources	16.7%
Energy	2.0%
Base Metals	0.7%
Battery Materials	5.9%
Gold	8.0%

When we find a theme in the "Cyclical" segment that we like, there are several non-index related exposures that are possible. There are many small retailers, for example, outside of the index that have exposure to a specific area within the consumption cycle that we are targeting.

Resources also offer a differentiated opportunity with some 6 per cent of the index represented by battery-related mineral stocks. These are stocks where the commodity exposure – lithium, graphite and cobalt – are key constituents for the coming growth of electric vehicles. This and the nickel players embedded in the base metals exposure of the index, represent interesting growth options in the future. We expect this sector faces rising demand as electrification of the developed world's passenger transport fleet takes hold.

From Rockstars to Stable Compounders to Cyclicals to Battery Minerals and on to Gold, there is a lot to cover and a lot of opportunities.

Dominic and I spend most of our time pounding the street, meeting with companies and their management team to hunt out investment opportunities which fit our process. I look forward to you joining the Montgomery Small Companies Fund and sharing this journey with us.

This article was written on 16 September 2019. All share and other prices and movements in prices are on this date.

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MONTGOMERY