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BEST of the BEST

THE ONLY PRESCRIPTION FOR

HEALTHY FINANCES

ISSUE 29: APRIL 2020

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THE

MONTGOMERY FUND

MONTGOMERY
INVESTMENT MANAGEMENT PTY LTD

MINIMUM INVESTMENT $25,000

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We don't change course or switch boats half-way across the stream, and The Montgomery Fund has the ability to retain cash when the market appears expensive.

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The Montgomery Fund focuses on owning high quality businesses – purchased at attractive valuations – to generate superior returns over the long term.

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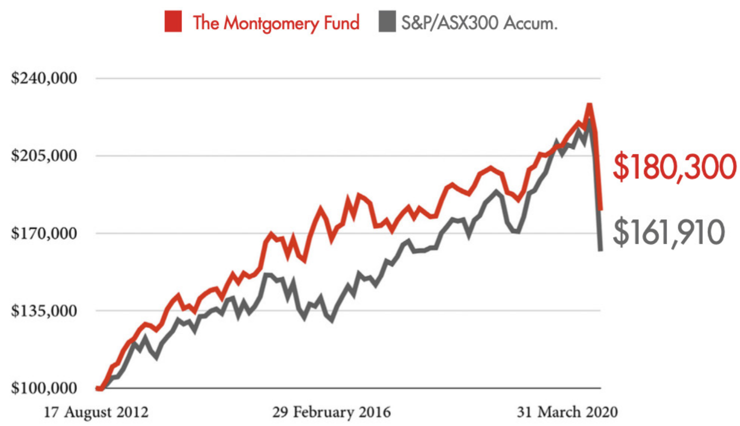
Performance to 31 March 2020



The Montgomery Fund aims to outperform the S&P/ASX 300 Accumulation Index (the Fund's benchmark) over a rolling 5-year period. Returns are since inception, August 2012, and assumes the distributions are reinvested. Past performance is not an indication of future performance.

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FROM THE EDITOR

Welcome to the second edition of ***Best of the Best*** for 2020. The biggest issues for investors now is the tension between the fact that the "curve is flattening" but the economy is in "freefall". As the articles in this edition reveal, amid the extreme levels of uncertainty, there are both risks and opportunities.

In essence the data sets on the virus and on the economy are big enough now that a reasonable assumption can be made about both. The key variables that are influencing investors and therefore markets are 1) the solutions being enacted to protect the public's health, 2) the economic consequence of those solutions, 3) offsetting central bank and government stimulus, and 4) progress towards a viable and scalable medical solution.

Bullish investors argue the intrinsic value of a company is the discounted cashflow of its earnings over time. And that recent conditions have delivered heightened uncertainty, which in turn delivers mouth-watering price discounts. Importantly, in just a few months, the uncertainty will have passed, and we will have progressed sufficiently through the health crisis that analysts will start factoring-in earnings scenarios that look more 'normal'. In fact, that may already be happening.

It is fair to say that investors won't wait for the COVID-19 pandemic to be over, they merely need the worst to be behind us. The market's recent rally suggests investor already believe that, and perhaps they do so correctly because infection rates are falling and government impositions of social distancing and event cancellations are working. Importantly, and as we expected, the conclusion of the Easter break would bring with it plans for staged 'unlocking' of the lockdowns. Continued social distancing, scaled-up testing and proximity apps that trace infections should continue to keep a lid on infections.

In time of course, and with the world's biggest pharma companies and philanthropic organisations racing towards a successful countermeasure, it is expected that a permanent health solution will be found. And while we continue to live without a vaccine for HIV, Dengue Fever, Cold Sores and Hepatitis, we live regardless.

The possibility of a permanent solution represents an upside risk, while the downside appears known.

Perhaps most importantly, low interest rates are here for some time yet and low rates are very supportive for asset prices.

The bearish arguments are equally convincing but rather than go through them all here, it is vital to understand our job is not to pick market directions but simply to value the businesses being offered to us. Australia is the home of some sensationally high-quality companies, and in some cases they are being offered at 50 per cent off. If you believe you would emerge from a three-year hibernation to a world still talking about Coronavirus, you should probably refrain from investing in anything. If however you believe you would wake to a world that had moved on, it might be worth considering buying businesses with robust business models and balance sheets, after assessing their value on the basis they might earn nothing this year, may dilute existing shareholders with a deeply discounted rights issues, but following 2020, will begin to recover towards their 2019 earnings. On that basis you may just find some bargains.

Roger Montgomery

Chief Investment Officer

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Is it time to get back in?

Roger Montgomery, Chief Investment Officer

Roger discusses the philosophy of purchasing at a rational price, shares of an outstanding business whose earnings will be materially higher five, ten, twenty years from now. Put together a portfolio of these businesses and you'll do just fine. Do it near the bottom of a crisis, when fear is very high, and you can do even better.

With so many companies now trading at cut-price valuations, many of our readers are asking whether it's time to start buying again. Over the past six weeks many companies are down. And some of them are very high quality indeed. A new reality exists, and one with the same opportunities as 1987.

On October 19 1987, the US Dow Jones Industrial Average plunged in the proper sense of the word. It fell almost 23 per cent in one night. That was before trading halts existed to give investors and traders time to compose themselves. The crash, which reset a corporate debt binge, spread to the rest of the world, and Australia was not immune. Eventually the Australian All Ordinaries index would fall more than 50 per cent.

The reason I share this story is because, with the benefit of hindsight, it is easy to imagine having simply closed one's eyes and aggressively bought shares at the depths of the crisis. Hindsight is a wonderful thing, as it gives the imagination licence to make the past real.

Today, imagination isn't required. A new reality exists, and one with the same opportunities as 1987.

On March 20, I noted the S&P500 hadn't appreciated just how infected the US economy would become and that it was wise to have, as we at The Montgomery Fund did, plenty of cash. Back then most investors were still of the view that Coronavirus was a Chinese problem. I wrote then "The extreme but unknowable probabilities, combined with the most recent and relatively benign SARS experience, has had stock market participants preferring to believe a substantial stimulatory response from China would kick start a v-shaped recovery…The stock market however has not been alert to the real economy."

IF YOU ARE IN THE FORTUNATE POSITION OF HOLDING A VAULT FULL OF CASH, IT'S WORTH REMEMBERING WE ARE IN THE MIDST OF A GENUINE CRISIS THAT DELIVERS RARE AND OFTEN BRIEF OPPORTUNITIES TO BUY AT RIDICULOUSLY CHEAP PRICES

Since then of course the US has become alert, and investors have realised that Washington was not immune from Wuhan.

As I have said many times over the years, cash is most valuable when nobody has any. The recent sell off reflects a mad dash to raise cash as much as it does fears about the pandemic. The time for preparation, however, is now over, and it is probably too late to sell shares to raise a meaningful amount of cash.

Another option is to re-weight your portfolio. There are companies that haven't fallen significantly such as Woolworths, Fisher & Paykel or BHP. These probably won't rally as much as stocks that have been temporarily ravaged by their direct exposure to COVID-19 and society's response. Switching from defensive stocks, those that have held up really well, to companies more leveraged to an economic and market recovery is starting to make a lot of sense. It even makes sense for those who have some cash.

Of course, if you are in the fortunate position of holding a vault full of cash, it's worth remembering we are in the midst of a genuine crisis that delivers rare and often brief opportunities to buy at ridiculously cheap prices.

CASH IS MOST VALUABLE WHEN NOBODY HAS ANY

In the month that has passed since Wednesday 20 February, the Australian All Ordinaries Index has declined from a peak of 7,289 points to an intraday low of 4,958 points. That's a fall of almost one third.

Looking back at '87, it was a great time to buy high quality companies. In five years' time, we will look back to this moment in time with some satisfaction that we bought quality shares, or invested in a fund manager that does so.

Yes it is true that the global economy will approach and probably enter a recession. Economic data will make for depressing reading. Millions will lose their jobs around the world. Households will redouble their efforts to restore over-geared balance sheets, and the savings rate will increase. But interest rates have been cut to near zero for the medium-term and governments will do everything in their power to stop a "negative feedback loop" as massive stimulatory packages are announced. Bail-outs are already being enacted. Money is being printed and sent to the unemployed and residential and commercial landlords will be commanded by legislation to refrain from evicting tenants and share some of the pain.

Importantly, companies will remove their revenue and earnings guidance due to uncertainty and you can safely expect cashflows and profits to be torched for this financial year and much of next year. Dividends will be cut for the final half of FY20 and FY21 dividends may be suspended for many companies.

I expect Australian banks to cut their dividends. Banks borrow short-term and lend long-term. They make the most money when the yield curve is steeply positive. Today, central bank buying of bonds is flattening the curve. Incentives to lend are muted and profit growth non-existent.

Some companies will be forced, or will want, to raise capital. This is already happening. We have seen Flight Centre, Webjet and Cochlear come to market. As an aside, when you see a raft of companies recapitalising their balance sheets through deeply discounted rights issues, these usually accompany a market bottom.

The market bottom will be registered when fear is at its maximum. That moment may have passed, or it may be still ahead. It doesn't matter because your job is not to pile in at the very bottom. That is fools' gold. Your job, as an investor is to purchase at a rational price, shares of an outstanding business whose earnings will be materially higher five, ten, twenty years from now. Put together a portfolio of these businesses and you'll do just fine. Do it near the bottom of a crisis, when fear is very high, and you can do even better.

There have been seven bear markets since the early 1970s. That's an average of one every seven years. Five of the bear markets, 1974-75, the early 1980s, the early 1990s, the early 2000s, and the GFC from late 2007 until early 2009, all took approximately eighteen months to play out and all lost approximately 50 per cent from peak to trough.

Over the past six weeks many companies are down much, much more than that. And some of them are very high quality indeed. You don't have to invest all at once. You might commit some capital now, and a bit more in a few weeks and then a little more in a few months, but now is the time to plan and act. If you don't know which stocks are at risk of insolvency and which are rock solid, invest with an active manager that does. Don't look back on 2020 the way you look back on 1987.

This article was written on 02 April 2020. All share and other prices and movements in prices are on this date.

How should you think about cash?

Tim Kelley, Director, Senior Analyst and Head of Quantitative Research

Tim identifies some tentative conclusions to help inform the decision of when to deploy surplus cash.

One of the biggest questions facing equity investors today is when and how to deploy surplus cash that they may have available. This is a question we have studied extensively in recent weeks, and while we can offer no definitive answers, some tentative conclusions may help to inform this decision. With that in mind, we set out here a summary of key points coming out of our analysis of the COVID-19 pandemic to date, and some thoughts on what might lie ahead.

Firstly, the outlook in the near term, we think, is grim. Probably more so than markets yet appreciate, and we expect to see more bad news than good news in the coming weeks and months. However, we also see some glimpses of light a little further down the track, and some possible tailwinds to recovery.

Starting with the near term, by now nobody needs to be told that COVID-19 is a critical health emergency whose management has profound economic implications. Some of the drivers of this are worth reiterating:

- It has proven to be highly contagious. With asymptomatic patients able to transmit the disease it has also been able to hide in the shadows and spread largely undetected. In countries where it has gained a foothold, daily case growth rates in the order of 20-30% have been the norm, and compound growth at these rates turns small numbers into large numbers very quickly.
- It appears to be about an order of magnitude more lethal than seasonal influenza. It is too early to accurately assess case fatality rate, but expert opinion sits at around 1%, and our analysis leads us to fear that it could be higher still. Even at 1%, it has the potential to become a leading cause of death in the foreseeable future.
- Further, fatality rate is very much a function of the sustained growth rate of an outbreak. If healthcare systems get overwhelmed by rapid case growth, an inability to care for serious cases pushes the fatality rate quickly higher.

This combination of features mean that if it is allowed to get out of hand, the human toll could compound in a terrifying way. As a result, governments have little choice but to pursue draconian measures aimed to limit growth – the so called “flattening of the curve.” These measures, of course, are highly disruptive for some sectors of the economy, and will likely result in a sudden surge in unemployment and business failures. Government stimulus and support initiatives will soften the blow, but will come at a steep, and currently unknown cost, and will inevitably address only part of the economic damage.

Not only will the control measures be onerous, it appears likely they could be with us for quite some time. Global resources are being thrown at the “silver bullet” of a vaccine, but expert opinion suggests that 12-18 months may be the best case timeframe. We might hope that urgency and application of resources will accelerate these efforts, but at the same time, widespread deployment of a novel drug that has not been exhaustively tested for safety is a science experiment that should not be taken lightly.

This means that we could be in crisis mode for some time, and sustained economic disruption is its own form of contagion. As businesses in one part of the economy fail, their problems are quickly spread to other businesses who previously regarded those businesses or their employees as customers or debtors.

We note that some store has been placed in the idea that warmer weather might slow the progress of the virus, leading to more rapid success in containing it. However, while many respiratory infections including the seasonal flu and some coronaviruses do show strong seasonal patterns, this is far from guaranteed in the case of COVID-19. Some viruses, including some of the more recent zoonotic viruses, do not show a seasonal pattern, and published research we have seen does not support the idea that climate has played a significant role in the spread of COVID-19. Our own analysis of case growth rates across different parts of the globe similarly gives us no comfort that seasonal effects are having much impact.

ANY FORECAST, OF COURSE, IS HIGHLY UNCERTAIN, AND A CASE CAN BE MADE FOR SOME BUYING TODAY IN CASE THE NEAR TERM HOLDS BETTER NEWS THAN WE ANTICIPATE, BUT IT APPEARS TO US TO BE TOO SOON TO MOVE AGGRESSIVELY

Another argument for a more positive outlook is the apparent success of containment efforts in places like South Korea, and particularly in China which is further along the path than any other nation. While we agree that there are some encouraging signs there, for several reasons it is not clear to us that we should take too much comfort from these observations. These include:

- It is not clear that a Chinese-style containment program can be implemented within the constraints of Western government and culture. Particular features of the Chinese system that may have aided success include an absence of privacy laws that enabled the movements of an entire population to be tracked, and an ability to apply harsh sanctions to enforce quarantine and social distancing. Informing the Party of a neighbour's non-compliance may be the norm in China; dobbing on a mate in Australia is not. At least not yet.
- Even if these sorts of containment successes can be repeated elsewhere, we are yet to properly understand what happens when those containment measures are relaxed. As China progressively returns to a more normal mode of operation, we may find that hidden problems re-emerge. Similarly for South Korea. It is also worth noting that many European countries are following a trajectory closer to that of Italy than South Korea, highlighting the challenges involved.
- We are also inclined to be a little wary of the Chinese case data. On analysing the data from provinces outside Hubei, we find that the case experience has been surprisingly benign and consistent. While the points raised above may help explain why China has been able to effectively control new cases outside Hubei, they do not explain why the speed of recovery and rate of fatality appears to be significantly better in those provinces than (for example) in South Korea. The Chinese data also a shows consistency both across regions and through time that we would not expect from a naturally-occurring data set. We also see the Chinese Communist Party in the process of exercising tighter control over the COVID-19 narrative; a process that coincides with the expulsion from the country of significant numbers of Western journalists. All things considered, while the Chinese data offers some encouragement, we are reluctant to assume it tells the full story.

Drawing limited encouragement from the climate argument and the Chinese data, we anticipate that the coming weeks and months are likely to contain more bad news than good news. Possibly a lot more. Accordingly, even though equity markets have already fallen significantly and offer better value than they did, we are cautious about deploying the surplus cash we hold on behalf of clients.

Any forecast, of course, is highly uncertain, and a case can be made for some buying today in case the near term holds better news than we anticipate, but it appears to us to be too soon to move aggressively.

Looking beyond the near term, however, we do anticipate a recovery. On a 12-18 month timeframe, the successful development of a vaccine might be viewed as a back-stop, allowing a return to more normal conditions over a corresponding horizon. In addition, on a shorter timeframe we see some reasons for optimism that may not yet have drawn much attention. In particular, we see learning curve effects offering real potential to mitigate the social and economic damage during the remainder of 2020.

Currently, COVID-19 is an entirely new threat to our health and our economy and we start from a zero base in terms of our knowledge and experience in fighting it. As time passes, however, all aspects of our approach to dealing with it will improve. To give a few examples:

- Treatment protocols will improve. While a "silver bullet" vaccine may be some time away, there is a good chance that we will identify existing drugs and therapies that can shorten recovery times and mitigate against case seriousness; we will learn how to manage cases more effectively and without putting at risk health care workers, as happened in the early part of the outbreak;
- Production of protective equipment, medical consumables and other supplies necessary to the fight will be ramped up and export restrictions currently being applied around the world will be relaxed;
- Our understanding of social distancing and other non-pharmaceutical interventions will improve. We will learn which interventions offer the greatest health impact at the lowest cost, and community compliance will improve as the measures become more familiar;
- Importantly, testing methods will improve, as they have already begun to do. Tests will become cheaper, faster, more sensitive, and more widely available;
- Our capacity to track and manage the prior contacts of those who do test positive will improve, allowing further spread to be contained more quickly and reliably.

To appreciate how significant these learning effects may be, consider for example the current border restrictions in force and their devastating impact to airlines and travel companies. In a world where testing for COVID-19 is cheap, accurate and readily accessible, it could be feasible to lift travel bans, subject to a requirement that all travellers first test negative.

It is impossible to predict exactly what advances may be made in the months ahead or to what extent they might ease the health and economic burdens, but we can be confident in expecting that improvement will come. Once case numbers are manageable and we are confident they can be kept there, economic recovery can be given greater focus.

Accordingly, while we anticipate further bad news in the near term, we are optimistic about an improving outlook over a slightly longer timeframe. As events unfold, we will be watching closely to try to discern the signs of a turning tide and ensure that clients are not left behind when recovery does come.

This article was written on 23 March 2020. All share and other prices and movements in prices are on this date.

Four criteria we are considering before buying shares in this market

Joseph Kim, Portfolio Manager and Head of Fundamental Research

Joseph shares four key criteria that we are presently focused on, with a view to investing on a 12-18 month time-frame in anticipation of a potential recovery.

With the Australian market in freefall, readers and clients alike have asked us where we are looking to invest. While we continue to monitor the fluid situation closely, we have established some key criteria that we would look to satisfy in anticipation of a potential recovery.

Over the past few weeks, the term "coronavirus" has well and truly entered the world's lexicon, devastating populations, exposing weaknesses in health systems and global supply chains, and putting a halt to broader economic activity. The equity market has for the large part reflected the uncertainty faced by investors, with some of the most significant one-day falls and intra-day swings we have experienced in the history of financial markets (-8 per cent to +4 per cent on Friday, 13 March comes to mind).

While The Montgomery Fund has not been immune, we have held a significant cash balance in the fund on the potential for a less benign coronavirus outcome than investors initially anticipated – which it would now be fair to say is worse than our initial, more cautious assessment.

However, with the Australian market down approximately 30 per cent from its recent peak at time of writing, many of the questions we are fielding from investors are focused around what we are looking to buy (which may be a sign that wide-spread capitulation has yet to occur!). While not exhaustive or prescriptive in nature, the following categories are the types of businesses that we are presently focused on, with a view to investing on a 12-18 month time-frame:

1. Quality companies with strong business fundamentals without structural impairment due to coronavirus – that is, the slowdown represents missed or delayed earnings, rather than impaired earnings
2. Asset backed companies with latent capacity that will recover over the course of time – many of these have balance sheet leverage, but we expect banks to prioritise high quality assets with significant moats in their financing decisions over other weaker businesses
3. Companies where competitors may / will suffer from a prolonged shutdown, providing medium term opportunity for these companies to capitalise on weakness
4. Companies that will survive the downturn and should be well positioned in a recovery – these businesses are either economic sensitive, or more impacted as a feedback loop, but given the fall now appear more attractive on medium term return expectations

While it remains very early days in the evolving coronavirus crisis, the sharp falls in equity markets suggest investors are starting to price in the disruption to the economy. Financial system stability will remain top of mind in the short term, but it is our view we are yet to see significant second-order impacts to the economy, with first-order impacts – that is travel, education, hospitality bearing the initial brunt of changes to human behaviour.

However, we continue to seek quality opportunities that meet the above criteria should selling become indiscriminate given the potential for these businesses as the world "returns to normal".

This article was written on 18 March 2020. All share and other prices and movements in prices are on this date.

Looking through market volatility for opportunities

Gary Rollo, Portfolio Manager

Gary identifies four of the Montgomery Small Companies Fund's exposures and discusses how as active managers, we expect market volatility to create individual stock investment opportunities.

As we look ahead the key questions for markets is how long will global economies remain closed for business, and what will demand look like on the other side of the valley? The March quarter was challenging for investors and the global macro backdrop remains highly fluid and uncertain and we are yet to form a clear picture around the duration of the shutdowns, the extent of the economic impacts or the effectiveness of the policy responses.

AS ACTIVE MANAGERS, WE EXPECT MARKET VOLATILITY TO CREATE INDIVIDUAL STOCK INVESTMENT OPPORTUNITIES AND WE WILL BE WORKING AS HARD AS EVER TO UNCOVER THE BEST RISK-REWARD PROSPECTS

In the coming weeks and months, markets will need to digest a deluge of bad news headlines as COVID-19 fatalities spike, economic data deteriorates and unemployment surges around the world. Markets do attempt to look forward, however such uncertainty will likely mean that volatility will stay elevated.

As active managers, we expect market volatility to create individual stock investment opportunities and we will be working as hard as ever to uncover the best risk-reward prospects.

Our small caps positioning

Against a rapidly evolving macro backdrop, the Montgomery Small Companies Fund exited March with nearly 21 per cent cash and we believe the portfolio is relatively well positioned to manage the downturn as we see it today.

Across the market capitalisation spectrum, 36 per cent of the portfolio is invested in companies with a market cap. exceeding $1 billion and another 12 per cent is invested in companies above $500 million, while only 9 per cent of the Fund is invested in the sub $250 million market cap bracket.

Although we expect the recent sharp sell-off to present some outstanding money-making opportunities over the medium-term, for now we have positioned the portfolio relatively defensively.

We will continue to make changes on a dynamic basis, as you would expect us to. We will undoubtedly have investments that will be challenged in the short-term, but overall, we feel the portfolio is positioned to take advantage of the opportunities that are being presented. We have the cash reserve and flexibility to make those decisions when the time comes.

Four of our investment exposures include:

- Telecoms & Datacentres – companies like Spark (ASX:SPK), NEXTDC (ASX:NXT) and Macquarie Telecom (ASX:MAQ) have long life assets, excellent competitive positioning and annuity revenue streams that we expect to continue, largely uninterrupted through a tougher economic period.
- Utilities – these assets literally keep the lights on, and whilst we expect there will likely be lower demand for power, and weaker power prices, these businesses have significant long-term asset backing, strong cashflows, resilient capital structures and competitive positions that will not be degraded during a downturn.
- Growth Technology – Appen (ASX:APX) is a company we like, its business model is particularly well placed considering its crowd workforce is set up remotely, and demand from the big global tech players should hold up relatively well.
- Resources – including Gold. Our resource investments have very strong balance sheet positions (net cash) as well as portfolios of competitive cash generating assets. Our gold miners are generating strong margins and are all Australian based, positioned to generate strong cashflows from the combination of high gold price and weak Australian dollar.

Our research is focussed on what signposts will ultimately guide our decision to redeploy capital, into the best risk-reward opportunities.

There are plenty recapitalisation opportunities as corporates address their need for equity to see them to the other side of this crisis and expected economic recovery. The fund is well positioned with cash ready to fund the best of these opportunities or to take advantage of low prices for stocks that can make it there under their own steam.

The Montgomery Small Companies Fund own shares in Spark, NextDC, Macquarie Telecom and Appen.

This article was written on 08 April 2020. All share and other prices and movements in prices are on this date.

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