MONTGOMERY ALPHA PLUS FUND

Annual Letter to Investors

July 2019

MONTGOMERY

IMPORTANT INFORMATION

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To our Investors:

July 2019

Fund Strategy Revisited

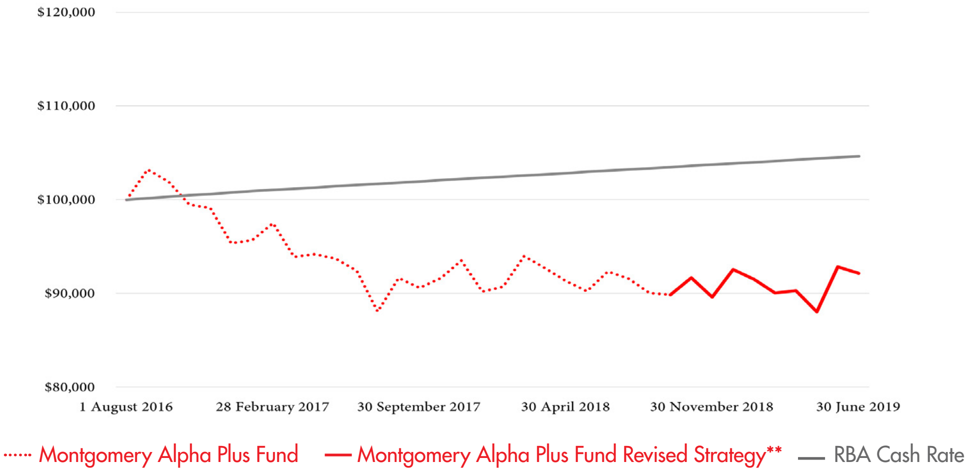
In last year's annual letter to investors in the Montgomery Alpha Plus Fund (The Fund), we set out the results of a detailed analysis of The Fund's strategy and outlined a set of proposals to improve the strategy to deliver more consistent performance. Those proposals were implemented at the start of October 2018, and in this year's letter we review the early results following their implementation.

To briefly recap, when we first established The Fund, we designed a stock selection process that incorporated two main elements: business quality and forecast return. The Fund would seek to take long positions in higher-quality ASX-listed businesses that were forecast to have strong investment returns and take short positions in lower-quality ASX-listed businesses that were forecast to have weak investment returns.

While we anticipated that this strategy would deliver good investment outcomes over long periods of time, it was also a strategy with something of a "feast or famine" character. In particular, being ASX-focused and having a bias towards high quality companies resulted in The Fund having a structural short exposure to the materials and energy sectors, which lack the pricing power typically associated with high quality businesses, and which also make up a large part of the Australian market.

While we believe that this sort of structural short exposure should be beneficial overall to long-term risk adjusted returns, there will be multi-year periods in which commodity prices rally strongly and these types of cyclical businesses do very well. As luck would have it, this is exactly what did happen following the launch of The Fund in 2016.

Figure 1: The Montgomery Alpha Plus Fund Performance Since Inception



**Annualised volatility: 9.1% Correlation with ASX200: -0.01%

Source: Fundhost

In particular, the Mining and Metals part of the Australian market rallied very strongly following the launch of The Fund (and continues to do so today). The Fund's structural short exposure to this part of the market presented strong headwinds resulting in negative returns for The Fund early in its life.

Recognising that these cyclical rallies presented a challenge to investor patience, we proposed last year to make two important changes to The Fund's strategy to deliver more consistent results:

- Firstly, we would remove the subjective quality overlay, allowing The Fund to adopt a more neutral weighting across industry sectors; and
- Secondly, we would allow The Fund to invest globally, rather than limit its focus to Australia.

These changes, implemented at the start of October 2018, have allowed The Fund to substantially eliminate the risk of underperformance during cyclical rallies and also to greatly increase diversification by accessing a much broader global pool of investment opportunities. This diversification is important, as it allows The Fund to pursue more attractive investment opportunities while keeping overall risk close to target levels. The Fund now holds market-neutral portfolios in each of five different regional markets, being Australia, the US, Canada, Hong Kong and Western Europe. Stock selection in each market is based on forecasts of expected investment return produced by quantitative models that consistently and objectively evaluate each of the several thousand stocks in The Fund's expanded universe.

The overall investment goals of The Fund remain unchanged: to deliver solid positive investment returns that are uncorrelated with equity markets, and with annual volatility below that of equity markets[1].

[1] Specifically, we aim for returns in the region of 8-10 per cent p.a. and volatility in the region of 10 per cent p.a.

While the goals are the same, the universe that The Fund invests in, and the way it approaches stock selection have changed significantly. We believe that these changes will facilitate better and more consistent performance for The Fund through time.

Distributions

With the conclusion of the financial year, The Fund goes ex-distribution, paying out an amount of 2.7120 cents per unit. Accordingly, after finishing FY2019 with a unit price of $0.8568, we started FY2020 with a unit price of $0.8296.

Since The Fund's inception, distributions have aggregated to 9.1919 cents per unit.

Table 1: Distribution History for The Montgomery Alpha Fund to 30 June 2019

Year to June	Distribution (cents per unit)
2017	2.3046
2018	4.1753
2019	2.7120
Total	9.1919

Review of Performance

The period since these changes were implemented is too short for a meaningful assessment of performance. However, pleasingly, the early signs have been positive. For the 9 months to the end of June 2019, The Fund delivered a positive return of slightly more than 2.5 per cent, equating to an annualised rate of 3.4 per cent and exceeding its benchmark, the RBA Cash Rate, which averaged just under 1.5 per cent on an annualised basis during the same period.

While this return is below our targets, it was achieved in a difficult environment for quantitative investors – a topic we will expand on later. Fund volatility of 9.4 per cent was in line with targets, and correlation with the S&P/ASX300 of negative 0.3 was significantly better[2] than the target of zero, but again, the timeframe is too short to draw robust conclusions.

Market Environment

Where previously The Fund's stock selection methodology included an assessment of business quality prepared by our analyst team, the changes to Fund strategy mean that it now employs a purely quantitative methodology.

[2] For an investor with equity exposure in their overall portfolio, an investment with a negative correlation to equities (and a positive return) offers additional diversification benefits, beyond those offered by a zero-correlation investment. However, this result is likely driven by short timeframe, and over the long run we expect The Fund's correlation with equities will be closer to zero.

This means that stock selection is driven by computer models built on detailed analysis of historical financial data to identify patterns in stock performance and determine the factors that can separate "good" investments from "poor" investments.

As a simple example, if we can demonstrate a correlation between a particular financial characteristic, such as forecast free cash flow yield, and future return performance, The Fund is more likely to tilt the long portfolio towards companies that have a higher forecast free cash flow yield. We analyse a wide range of potential factors for each region The Fund invests in, and each regional model will typically employ around 30 different factors to distinguish the stronger from the weaker investment candidates.

We believe that this type of data-driven approach to investing is increasingly relevant in a world where increasing volumes of data can be accessed in electronic form, and we are certainly not alone in applying computing power to investment questions in this way.

Other like-minded investors follow a similar approach, and while part of our job is to try to maintain an information "edge" and to develop unique insights not held by others, many of the factors and relationships we identify will also be found by those other investors.

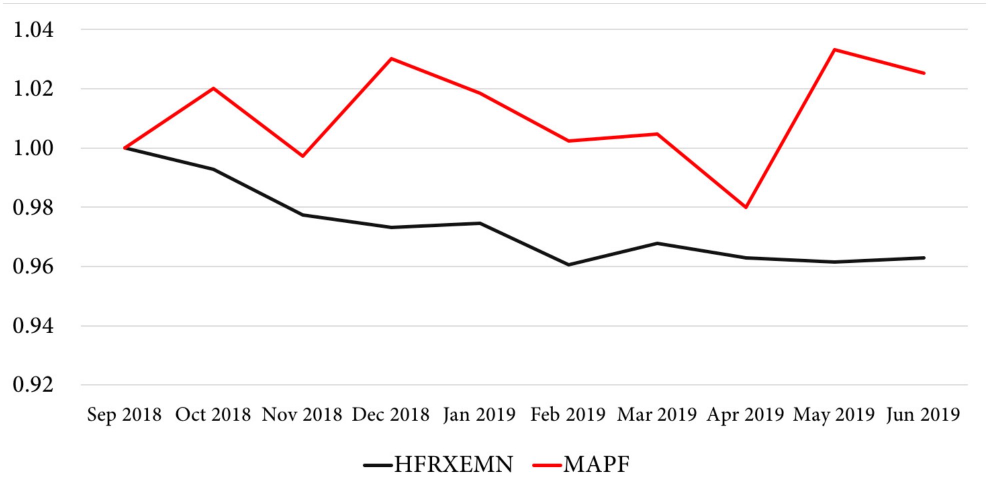
It is also relevant to note that the factors that we and other quantitative investors aim to exploit will have periods of fluctuating performance. As with any style of investing, there will be times when the factors we are targeting work well, and performance will be correspondingly strong, and times when these factors work less well, and performance will be correspondingly weaker.

This may happen, for example, when the stock-specific factors we are seeking to exploit are overwhelmed by other, less predictable forces, such as government interventions, unexpected changes in the macro environment, or shifts in market sentiment.

For these reasons, it is helpful in assessing the performance of The Fund to consider the performance of other, similar funds, or ideally, broad indexes of the performance of similar funds.

One index that we believe provides a useful comparison is the HFR Equity Market Neutral Index, which tracks the performance of equity market neutral funds that use a quantitative methodology. As shown on the next page, in the 9 months to the end of June, this index has delivered consistently negative returns, indicating a challenging period for this investing style. While The Fund has delivered returns that are below our long-term objectives, it has delivered a positive return through this period, comparing favourably with the index.

Fund Comparison with HFR Equity Market Neutral Index



Source: Bloomberg; Fundhost

We see a similar pattern in looking at other comparable funds and indexes, and this is further supported by press coverage suggesting that quantitative and factor-based investors generally have found the recent market environment challenging.

In this context it is pleasing the see The Fund deliver a positive return. While that return has been below our target levels, it seems reasonable to expect stronger performance may be realised in a more accommodating market environment when quantitative factors have stronger predictive ability. We note again however, that the revised Fund strategy has been in place for only a very limited time, results will vary from month-to-month, and significantly more history will be needed to draw robust conclusions.

We should also note that there is no way of knowing when difficult market conditions might improve. We anticipate that periods of softer performance can sometimes be drawn out as investors with a shorter-term orientation exit underperforming strategies, placing additional selling pressure on the types of stocks favoured by those strategies. It is certainly the case that some quantitative investors have experienced large outflows in the past year, and until this process is exhausted, some headwinds could persist.

Fund Reporting in Future

October 2018 marked a significant milestone for The Fund, moving it from an ASX-focused vehicle employing a combination of quantitative and subjective methods, to a purely quantitative global vehicle. In many ways it would make sense to have launched the revised strategy as a completely new fund. However, continuing under the existing fund vehicle means that investors in the "new" Fund will not pay any performance fees until the underperformance from the early part of The Fund's life are completely recovered. This seemed like the right approach.

In reporting going forward, however, we will focus (as we have done in this letter) on the performance of the "new" Fund, and unless otherwise noted, figures quoted for return, volatility and correlation will be for the period post-October 2018.

How to Use The Fund

As with other equity market neutral funds, The Fund aims to deliver returns that are uncorrelated with equity markets. There are some obvious advantages to this, including the potential to shield investors from the effects of a possible equity market downturn – a feature that takes on additional significance in an environment of elevated equity prices.

However, the potential benefits of uncorrelated returns go beyond this. In particular, The Fund is designed to contribute to lower overall portfolio risk for investors with equity exposure in their portfolios. Investors can decide whether to choose lower market risk, or convert it into higher expected returns by increasing their exposure to more risky assets.

Earlier this year we published a detailed account of these benefits and how investors can ensure they take full advantage of them. The paper is available here, and if you haven't read it previously, we encourage you to have a look.

Continued Development of Fund Strategy

Since the revised Fund strategy was launched in October 2018, a number of further incremental enhancements have been incorporated into The Fund's processes, including more frequent portfolio rebalancing to better capture shorter-term information, changes to our trading to reduce transaction costs, in-house development of more sophisticated data cleaning and processing software, and the addition of a number of new and unique factors to our forecast models.

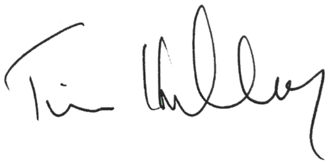
More broadly, we expect that equity markets will only become more competitive over time, and that investors need to continually improve at a similar or faster rate to sustain an investment edge. In relation to The Fund, we are excited about the improvements implemented already, but continue to work to further improve our methods. There are several components to this ongoing improvement effort, including:

- Investing in continuing research to develop and identify new stock selection factors and improve existing ones;
- Accessing new and expanded data sets on which to apply the research effort; and
- Exploring opportunities to further extend The Fund's investment universe into new geographies and into mid and small-capitalisation companies where attractive opportunities may be available to nimble investors; and
- Continuing to refine our information systems.

While we are confident that the foundations for strong long-term performance have been laid, we are conscious of the need to continually evolve, and are excited about the potential value in the research projects currently underway.

Thank you for your support of The Fund in FY2019. Following a bumpy start, it is pleasing to be able to report positive results (albeit not yet at the level we would like), and we look forward to being able to deliver the full potential of The Fund in the years to come.

Sincerely,



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