MONTGOMERY GLOBAL FUND

Annual Letter to Investors

July 2019

IMPORTANT INFORMATION

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To our Investors:

July 2019

Over the 2019 financial year, the Montgomery Global Fund (the Fund) returned 7.74 per cent, net of fees, versus the MSCI World Net Total Return Index in Australian dollar terms (the Benchmark) which returned 11.95 per cent. Since inception four years ago, the Fund has delivered 56.77 per cent, net of fees, versus the Benchmark which returned 47.29 per cent over the same period. It should be noted that the Fund has averaged around 18 per cent in cash holdings since its inception which, in our view, enhances the quality of the return profile we have achieved for our investors.

Distributions

With the conclusion of the financial year the Fund paid a distribution of 15.5592 cents per unit. On the date that the Fund goes ex-distribution, the unit price declines by an amount equal to the distribution. After ending FY19 with a unit price of $1.3299, we commenced FY20 with a unit price of $1.1742

Table 1: Distribution History for the Montgomery Global Fund to 30 June 2019

Year to June	Distribution (cents per unit)
2016	NIL
2017	12.1023
2018	7.5200
2019	15.5592
Total	35.1815

Over the four-year life of the Montgomery Global Fund, distributions have aggregated to 35.1815 cents per unit.

Table 2: Annual Performance Information

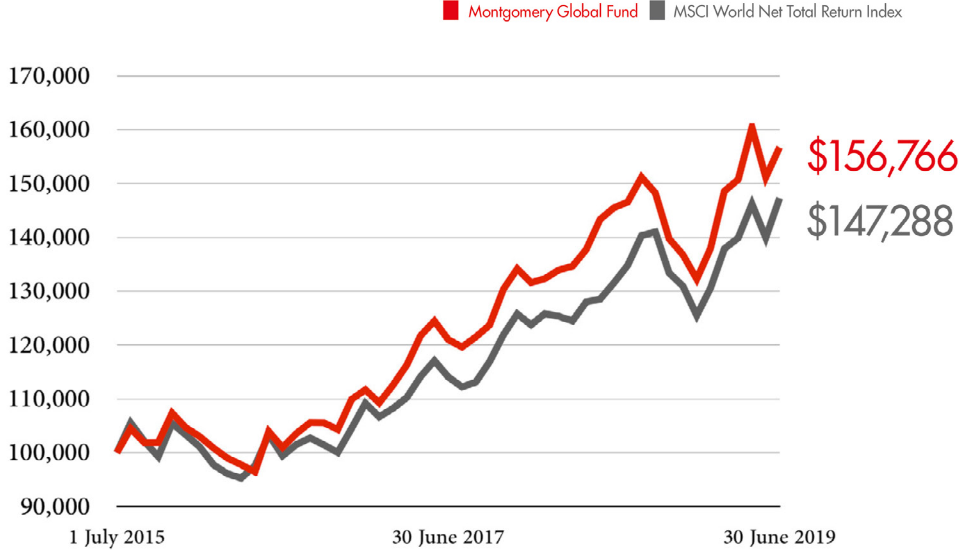
Period	Returns			Maximum Drawdown***		Annualised Volatility	
	The Montgomery Global Fund	MSCI World Net Total Return Index*	Relative Performance	The Montgomery Global Fund	MSCI World Net Total Return Index*	The Montgomery Global Fund	MSCI World Net Total Return Index*
2016	+1.0%	-0.6%	+1.6%	+ 11.9%	+ 14.0%	+ 13.2%	+ 14.6%
2017	+19.9%	+14.7%	+5.2%	+ 4.6%	+ 5.5%	+ 9.4%	+ 9.2%
2018	+20.2%	+15.3%	+4.9%	+ 4.9%	+ 5.9%	+ 9.4%	+ 9.5%
2019	+7.7%	+12.0%	-4.3%	+15.7%	+16.0%	+12.7%	+11.3%
Since Inception	**+11.9%****	**+10.2%****	**+1.7%****	**+ 15.7%**	**+ 16.0%**	**+11.3%**	**+ 11.4%**

* In Australian Dollars

**Compound Annual Returns

*** Annual drawdown figures show the maximum decline with the relevant year

Figure 1: Montgomery Global Fund Performance Since Inception



Source: Fundhost

You should also be aware that our approach in managing the Fund is not to aim for a particular level of distribution, but rather to aim for the best possible total return.

Market Commentary

Given the numerous uncertainties out there in the world today which are significant for global equity investors, it is perhaps timely to take a step back and be reminded of how we think about the Fund's portfolio construction and why we believe this approach will add durable value over the long term for our investors.

The exposures we seek to build into our global portfolio can be characterised as follows:

- A collection of privileged global business models, in structurally growing industries, that remain materially undervalued today;
- A set of exposures which are selectively diversified by geographical region and by industry sector; and
- A set of currency exposures which are globally diversified and seek to maintain global purchasing power for our investors in the Fund.

In constructing a portfolio of high-quality global businesses which are undervalued, we seek to deliver outperformance over the Benchmark over time. And by owning businesses which are positively exposed to structural industry tailwinds, we can look-through much of the short-term market volatility and have peace of mind that the businesses we own will likely be significantly more valuable in the future, than they are today.

And there is no shortage of risks out there today which are significant to global investors. Whether it is the changing winds of global monetary policies – which in the space of nine months have changed

from tightening, to neutral to easing; or the ongoing dispute between the US and China; or the uncertainty around how Brexit will unfold. And let's not forget that a war between the US and Iran almost broke out in recent weeks.

Notwithstanding the return of volatility in global equity markets, the Fund seeks to provide investors with exposures to a set of undervalued, high-quality global businesses which are experiencing industry tailwinds which are structural in nature.

For example, consider Vivendi (Euronext: VIV), owner of the world's largest record label, Universal Music Group (UMG). As consumer behaviour continues to evolve from purchasing individual music tracks to subscription-based digital streaming, UMG's revenue growth continues to accelerate at a significantly higher incremental profit margin. 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 China today it's around 1 per cent. This will underwrite structural growth in global digital streaming revenues of around 20 per cent per annum, well into the next decade.

Or the structural migration of advertising spend onto digital platforms that offer highly-targeted forms of advertising – thereby driving the highest rates of ad spend ROI for the digital marketer. The world has really divided into two distinct digital advertising markets: (i) the world, ex-China, which is dominated by Google, owned by Alphabet (NASDAQ: GOOGL), and Facebook (NASDAQ: FB); and (ii) China, which is dominated by Alibaba (NYSE: BABA) and Tencent (HKEx: 700). In studying the quarterly disclosures of numerous consumer facing businesses, including nearly all the major CPG companies, it is clear that marketing budgets are being significantly re-weighted towards higher-returning digital channels all around the world.

Here is what Kimberly-Clark (NYSE: KMB) CEO, Michael Hsu, had to say earlier this year: "Today, digital is approximately half of our working media mix – and that percentage is growing... the ROIs are a multiple of what our traditional ROIs are..."

And this is not the only technological transformation taking place inside the enterprise. Readers will know that substantially all businesses today – both large and small – are moving at least some of their technology infrastructure to the cloud. You can think of the cloud as an external source of storage, compute, services and applications. There are enormous cost, efficiency and security advantages in outsourcing this technology infrastructure. Today, Bernstein estimates the total addressable market for cloud services to be approximately US$1.9 trillion. And yet, aggregate cloud spend is less than 10 per cent of this total addressable market, meaning there is a very long runway ahead for growth in cloud related revenues. Microsoft (NASDAQ: MSFT) is arguably the most well-positioned business to take advantage of this structural growth in cloud related spend. Its offering spans the cloud-based compute/storage infrastructure as well as the enterprise applications that sit on top of this infrastructure. Indeed, Microsoft is in a particularly well-suited position given that Windows is installed on around 90 per cent of the world's PCs and Office is used by around 85 per cent of enterprises. This creates a high degree of customer captivity that Microsoft is in the very early stages of monetising.

Demographic changes are structural trends to which we seek to be positively exposed. In the US, for example, the aging population sees 10,000 Americans turn 65 years old every day. This is creating enormous demand for healthcare services. UnitedHealth (NYSE: UNH), the largest health insurer in the US, is particularly well positioned to grow its insurance business – particularly its highly-popular Medicare Advantage offering which is available to Medicare recipients aged over 65 years old.

But it is actually UnitedHealth's underappreciated healthcare delivery platform, Optum, which has the greatest opportunity of profitable, structural growth. Optum is a technology and data-enabled healthcare delivery platform, not only for UnitedHealth's own insurance business, but for more than 80 third-party payers. Optum is seeking to use data and technology to deliver healthcare more efficiently and effectively to drive better outcomes for patients and at lower costs, creating value in which Optum will share.

At the other end of the demographic spectrum in the US, readers may be interested to know that the children of the baby boomers – known as the "echo-boomers" – are around 28 years old today. Over the next 10 years, population growth in the all-important 35-44 year old cohort in the US will be around six million. By comparison, growth in this cohort was negative over the last 10 years. This favours demand for housing and those businesses exposed to demand for home renovations. We own Floor & Décor (NYSE: FND), a specialty retailer of surface flooring – the preferred supplier of flooring products to professional customers and known for its 1,500 SKU in-stock, job-ready inventories.

Finally, Asian demographics represent another structural trend that is providing great opportunities to the disciplined investor. Over the next 15 years, more than 80 per cent of the growth in middle-class spend will stem from the Asian-Pacific region. And private financial wealth levels in Asia will continue to grow at around 10 per cent per annum for many years to come. In China, Ping An (HKEx: 2318) is an industry leader in life insurance and wealth management offerings. It is a leader in technology and data-enabled design and distribution of insurance and wealth products. And given that its average customer age is only around 38 years old, it is set to grow structurally with the wealth of its customer base.

Outside of China, Prudential (LSE: PRU) is a clear leader in Asian life insurance with a top-two market position in Indonesia, Singapore, Hong Kong, Malaysia, Vietnam, India and elsewhere.

Asian insurance markets are around half the size, on average, of western insurance markets as a percentage of GDP, suggesting there is substantial penetration ahead. And Prudential's Asian business has delivered circa 20 per cent post-tax economic returns consistently for years – and we expect this performance to continue for many years to come.

The growth in the wealth levels of the Asian middle-class will also drive structural demand growth for services like travel. Chris Demasi explores our thesis in Airbus (Euronext: AIR) below, which is positively exposed to structural demand for aircraft for decades to come.

It is important to observe that each of our theses not only identifies the sources of business quality and structural growth opportunities; but also makes the important assessment as to whether (or not) the business in question remains undervalued today. After all, not even the greatest growth story in the world can stop you from losing money if you overpay for an asset.

Case Study: Airbus

The Montgomery Global funds have successfully held long positions in Airbus for several years. Looking forward, we think Airbus remains a wonderful investment opportunity because it is a high-quality business with a long runway for profitable growth that is not fully appreciated by the market.

United Europe success story

In the years following the end of the second World War, European aircraft manufacturers found competing with larger American peers Boeing, McDonnell Douglas and Lockheed increasingly difficult. While the Europeans might have been just as innovative as the Americans, acting independently they were too small to bear development risks and achieve production efficiencies.

Though not without hiccups along the way, European aviation companies and their governments seem to have heeded the advice of Britain's wartime Prime Minister, Sir Winston Churchill, to great effect: "If Europe were once united in the sharing of its common inheritance there would be no limit to the happiness, prosperity and glory…We must build a kind of United States of Europe"

Negotiations over a collaborative European approach began at the 1965 Paris Air Show and by 1967 France, West Germany and the UK were working together on a new "Airbus". This paved the way for Airbus to be formally established in 1970 with German, French, British and Spanish partners. The consortium's first commercial plane went into service in 1974.

Today Airbus is the second largest aerospace and defence company in the world with €70 billion in annual revenue and an order book valued at almost half a trillion Euros across three operating segments. But the commercial passenger aircraft business is still the crown jewel in the Airbus empire, contributing 75 per cent of total company revenues and 90 per cent of profits.

Airbus is the world leader in producing passenger aircraft for commercial airlines, including the narrow-body A320, the wide-body A350, and the world's largest passenger airliner, the A380. In addition, Airbus Helicopters is a global leader in civil and military rotorcraft, and Airbus Defence and Space is a leading supplier to militaries and the space industry.

Reflecting its pan European heritage and global expansion, Airbus is headquartered in the Netherlands; with its main office in France; shares traded in Paris, Frankfurt and Madrid; and assembly lines and suppliers located around the world.

Leading a two-horse race

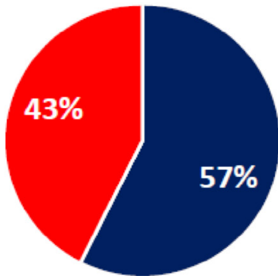
Airbus is undoubtedly a high-quality business, which stems from its market-leading position in the attractive industry for passenger aircraft and is demonstrated by return on equity above 30 per cent.

Airbus leads US-based Boeing in a global duopoly for passenger jets. The A320 family accounts for almost 60 per cent of all narrow-body plane orders worldwide, leading Boeing's 737 platform. In the market for wide-body planes, Airbus' A330 and A350 together account for almost half of the global industry order book. Airbus's backlog of more than 7,000 orders represents nine years' worth of production and secures its leadership for the foreseeable future.

This privileged market structure is virtually impervious to disruption because the barriers to entry are extremely high for potential new entrants.

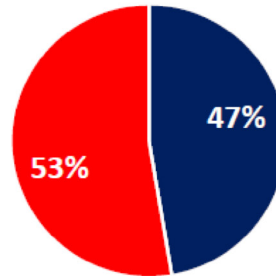
Market share of backlog (number of aircraft)

Narrow-body



■ Airbus ■ Boeing

Wide-body



■ Airbus ■ Boeing

Source: Company filings

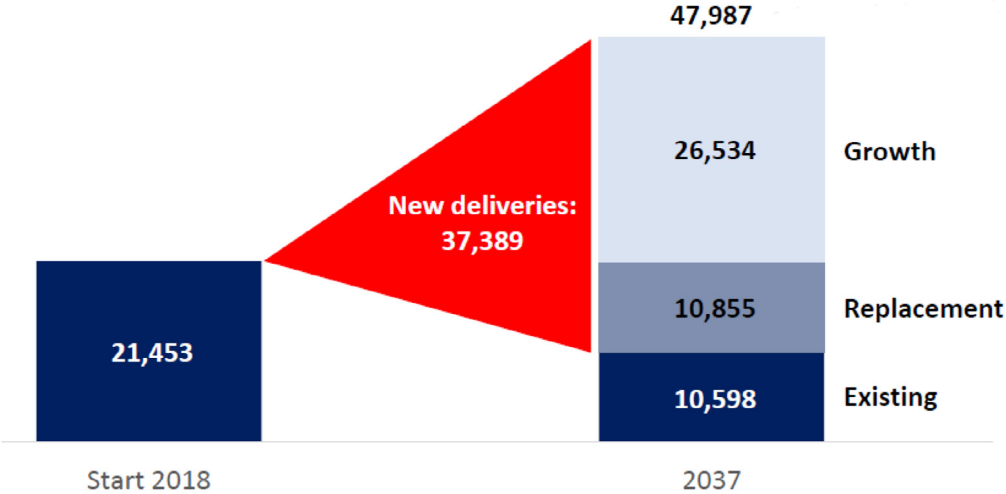
Initial capital outlays for aircraft development can easily reach tens of billions of dollars, run over-budget, and have pay-back periods longer than a decade. For example, Airbus expected development costs for its A380 to be $10 billion in 2000 but they ultimately expanded to $25 billion and may not be fully recouped. The technological expertise required to develop aircraft and the commercial relationships needed to sell them to airline and leasing customers years in advance are also built over decades. Deep pockets, know-how, know-who and time are strong advantages for Airbus.

Tailwinds for decades

Airbus will benefit from structural growth in air travel for decades. Airbus estimates that more than two billion people will join the global middle class over the next 20 years. Higher disposable incomes for this cohort are expected to drive global air passenger traffic to more than double over this period.

At the same time airlines around the world are operating their fleets at the highest load factors (or fewest spare seats) on record. In order to meet such robust growth in air travel airlines will need to expand their fleets significantly. Airbus estimates that the global fleet of passenger planes will more than double over the next two decades and airlines will need to purchase over 37,000 new jets. Airbus A320 and A350 families feature prominently in airline expansion plans.

Global passenger aircraft fleet (number of aircraft)



Source: Airbus

Even with Airbus close to producing the A320 family at a rate of 60 per month, and stepping up in coming years, it still cannot deliver the single-aisle jets quickly enough. A320 delivery slots are full looking out four years.

Insatiable demand for the A320 has allowed Airbus to command premium pricing at the same time as customers are choosing larger, longer-range, next-generation engine variants that are all more profitable for Airbus. At the Paris Air Show this month Airbus launched the A321XLR with 15 per cent higher range, 30 per cent lower fuel burn, an extra fuel tank, more seating and immediately gained hundreds of orders.

Meanwhile production of the A350 will ramp well above 100 this year. Profit margins will turn positive and inflect upwards as the program continues down the industrial learning curve, unit costs fall, and pricing improves.

Stock taking off

Ultimately, we see a potential path for Airbus to grow volumes over the next two decades at mid-single-digit annual rates, with better pricing and product mix adding another couple percentage-points to top line growth each year, and profit margins doubling. In this scenario we think the stock is worth €200 per share today, or 60 per cent more than where it is currently trading.

Said another way, we think the market is underappreciating the runway for growth and the potential for improved profitability ahead of Airbus. The current share price of around €125 implies the market is taking a moderate view of production volumes than the industry requires, failing to recognise price/mix benefits, and consequently underestimating profit margin expansion over time.

* * *

In closing, on behalf of the entire Montgomery Global team, I would like to thank each and every one of our investors for the trust you continue to place in us to preserve and grow your wealth over time. We continue to work tirelessly to deliver our investors attractive returns and a positive experience in your partnership with us. We seek the highest standards of discipline and integrity in how we operate, while continually looking for opportunities to improve our offering.

Sincerely,

Andrew Macken

Chief Investment Officer

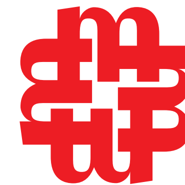
Montgomery Global Fund

Christopher Demasi

Portfolio Manager

Montgomery Global Fund

MONTGOMERY GLOBAL INVESTMENT MANAGEMENT PTY LIMITED



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