# Montaka Global Access Fund

Montaka Global Investments

# QUARTERLY LETTER

MARCH 2020

UNIT PRICE[1] $ 0.9083

## FUND COMMENTARY

In the month of March, the Montaka Global Access Fund (the Fund) declined by 15.46 per cent, net of fees. This decline was much larger than the decline in the MSCI World Total Return Index in Australian dollar terms (the Global Market) of 8.60 per cent. One of the primary drivers of this material underperformance to the Global Market in the month stemmed from our decision to significantly reduce the Fund's net market exposure considering the ongoing COVID-19 crisis, which we expand on below. In the days subsequent to this decision, global equity markets put on the largest three-day rally since 1931 – a rally in which we participated to a far lesser extent than if we were more fully invested. Since inception, the Fund has increased by 1.84 per cent, net of fees, delivered with an average net market exposure of 48 per cent.

We acknowledge that many reading this report will be very disappointed with the short-term performance of the Fund. We are not happy with it either. That said, we stand by our decision to move the portfolio into a highly defensive position. And it remains positioned that way today, with a net market exposure of approximately 40 per cent at the time of writing this letter. As we describe below, there remains a very possible adverse scenario in which lockdowns and economic disruption persist for as long as it takes to develop a usable vaccine. While such a negative scenario is not certain, its likelihood is high enough that we believe staying defensive is the best position today.

## FUND PERFORMANCE


## PERFORMANCE ATTRIBUTION[1]* (%)

| | March 2020 |
|---|---|
| Long portfolio contribution | (26.62) |
| Short portfolio contribution | 5.13 |
| Change in AUD/USD | 6.03 |
| Net return | (15.46) |
| Since inception[2] | 1.84 |

## EXPOSURES (as at 31 March 2020)

| | % of NAV |
|---|---|
| Long exposure | 87.0 |
| Less: short exposure | (46.5) |
| Net market exposure | 40.5 |

## POSITION METRICS (as at 31 March 2020)

| | Long Portfolio | Short Portfolio |
|---|---|---|
| Number of positions | 23 | 35 |
| Largest position size | 8.9 | 2.6 |
| Smallest position size | 0.6 | 0.1 |
| Average position size | 3.8 | 1.3 |

Note: sizes shown as % of NAV

## TOP 10 LONG POSITIONS (as at 31 March 2020)

| | | % of NAV | | | % of NAV |
|---|---|---|---|---|---|
| 1 | Microsoft | 8.9 | 6 | S&P Global | 6.0 |
| 2 | Vivendi | 8.0 | 7 | Spotify | 5.4 |
| 3 | Facebook | 7.3 | 8 | Ping An | 5.1 |
| 4 | Alphabet | 6.9 | 9 | Rheinmetall Ag | 5.0 |
| 5 | Alibaba | 6.9 | 10 | Apple | 4.6 |
| Total top 10 long positions | | | | | 64.1 |

## FUND SIZE (NAV) ($M) (as at 31 March 2020)

| | |
|---|---|
| Montaka Global Fund | 126.7 |
| *of which:* Montaka Global Access Fund | 50.6 |

| PERFORMANCE (%) | 1M | 3M | 12M | 2 YR PA | 3 YR PA | COMPOUNDED ANNUAL RETURN SINCE INCEPTION | SINCE INCEPTION |
|---|---|---|---|---|---|---|---|
| **Fund (AUD)[2]** | **(15.5)** | **(17.4)** | **(15.2)** | **(4.5)** | **1.5** | **0.4** | **1.8** |
| Underlying Fund (AUD)[4] | (15.5) | (17.5) | (15.2) | (4.6) | 1.5 | 3.3 | 16.6 |
| Average Net Market Exposure | 41 | 55 | 51 | 49 | 47 | 48 | 48 |
| Global Market (AUD)[2,5] | (8.6) | (9.3) | 4.0 | 8.1 | 9.7 | 7.6 | 38.0 |
| Average Net Market Exposure[3] | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

1) The fund is forward priced; you will receive the price struck subsequent to the receipt of your application/ redemption request.
2) Inception: 1 November 2015; Ex-distribution of 1.9994 cents 30/06/2016, 7.4407 cents 30/06/2018 and 2.9395 cents 30/06/2019.
3) Based on average of month-end net market exposures
4) Montaka Global Fund; inception 1 July 2015
5) MSCI World Net Total Return Index in Australian dollar terms
* all exposures, metrics & positions are derived from the Underlying Fund (Montaka Global Fund)

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It is for this reason, we used the recent market rally to purchase a small number of relatively cheap put options on the S&P500 Index to help insure against the most negative of possible scenarios from here. Today is the day to preserve capital. The day will come when we rapidly increase our net market exposure into some extraordinary long-term opportunities which are ripening – one of which we include in this letter as a case study, Prudential Plc (LSE: PRU).

We think about the world in terms of the range of possible outcomes and the likelihood (or probability) of each outcome. This is different from trying to predict what will happen. We have no idea what will happen with respect to this COVID-19 crisis, and neither does anyone else. But mapping out the possible scenarios and assessing the likelihood of each is a critical step in arriving at an appropriate portfolio position. In the next section, we want to share with you the internal process we have followed (and have always followed) to assess the nature of the risk we faced with COVID-19 and the portfolio positioning we effected at each step along the way. We have included a set of charts to summarise these developments and decisions.

As we entered the calendar year, readers will know that we were optimistic for the prospects of equity returns. Interest rates had fallen significantly which increased the premium that investors were being paid to accept equity risk. Indeed, this premium had not looked so attractive for nearly four decades. Furthermore, many statistically significant leading macroeconomic indicators were pointing to accelerated economic growth across all major global economies. Our assessment was that the most likely outcomes for equities ranged between good returns and great returns. On this basis, we had a net market exposure in the range of 50-70 per cent in January-February 2020 period.

At the end of January, readers will know that we identified the tail-risk associated with COVID-19. At the time, we assessed this to be a Chinese regional risk and exited our Chinese exposure as a result.

By the end of February, Chinese data related to COVID-19 had improved significantly. Growth rates in cases and deaths had slowed and many parts of Chinese society were starting to come back to work. We used this improving Chinese data to reduce the probabilities of any potential COVID-19 catastrophes in the Western world. With the benefit of hindsight, these reductions in probabilities for the Western world were premature. Under-estimation of this tail, combined with (i) (already) lower stock prices; (ii) new monetary policy measures; and (iii) anticipated fiscal supports, led us to be as fully invested heading into March, with a net market exposure of approximately 70 per cent.

By the middle of March, we had observed the clear catastrophe that was unfolding in Europe. We also became very concerned with the lack of testing in the world's largest economy. The probability of much more severe and prolonged lockdowns in the US, UK, EU, Australia and elsewhere was now much higher than we had previously assessed. And this could have damaging effects on these economies, including job losses, business failures and lower asset prices.

On this basis, we did the largest amount of selling in the Fund's history in March, taking the net market exposure of the fund down to as low as zero. Furthermore, the composition of the Fund's portfolio changed:

- We reduced exposure to businesses with large fixed costs and revenues that were relatively more susceptible to disruption;
- We reduced exposure to financial services businesses that were exposed to credit (even if indirectly), given the elevated risks of credit events in the future; and
- We increased exposure to businesses with more resilient revenue lines in a COVID-19 world, including Microsoft (NASDAQ: MSFT), Vivendi (Euronext: VIV) – owner of Universal Music Group – and a new position in Spotify (NYSE: SPOT).

Towards the end of March and early April, while the risks in the US remained as high as ever, we did observe a clear slowing in the death rates and case rates in Europe. As we point out below, this does not necessarily mean we are nearing the end of this crisis. But the improvement is certainly better than the alternative and suggests that lockdowns are effective in reducing the spread of COVID-19 – a critical first step in containment.

Consequently, we reinitiated some European exposure and increased the Fund's net market exposure to approximately 40 per cent. At the same time, we used the recent market rally to purchase a small number of relatively cheap put options on the S&P500 Index to help insure against the most negative of possible scenarios from here. We also initiated some additional new short positions in Japan and Sweden – two specific countries that now appear like they are well behind in containing COVID-19 and are heading for more severe lock-downs.

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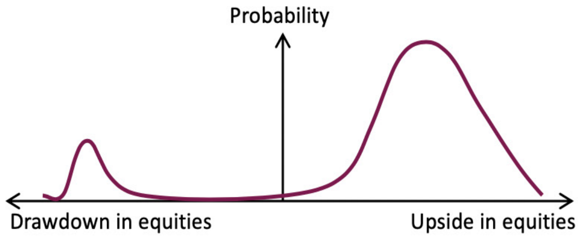
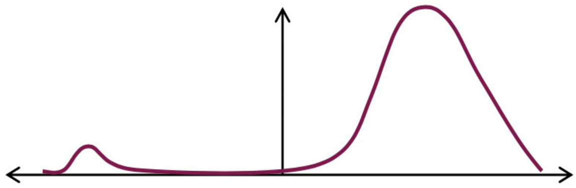
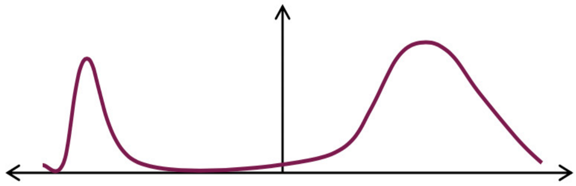
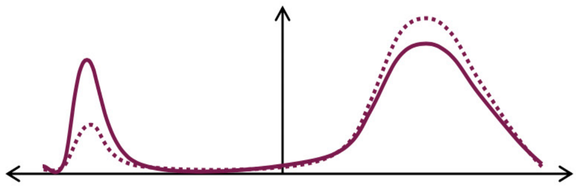
| Date | Assessment of Probability Distribution | Action |
|---|---|---|
| January |  | **52% net long** (Exited all Chinese net exposure) |
| February |  | **70% net long** (Rapid Chinese containment of covid) |
| March 16 |  | **0% net long** (Concerns over growth rates in EU, US) |
| Early April |  | **40% net long** (Added back EU exposure on improving data) |

Source: MGI

We now frame the possible scenarios looking forward from here with respect to the COVID-19 crisis. Our simplified scenario tree is shown below and maps out, at a high level, the path that each country might take to either a best-case, or worst-case scenario. There are two important takeaways from this scenario tree, in our view:

- Even in the best-case scenario, it is unlikely we will return to life as we knew it without a vaccine (which is estimated to be at least 12 months away). At best, strict measures of extreme social distancing will be required to minimise the chance of a case resurgence. This means that social and economic restrictions will likely remain in place until a usable vaccine has been developed.
- There are multiple paths to the worst-case scenario. Indeed, it would only take one country in the world to experience a strong resurgence in cases following the relaxation of their lockdown to potentially keep most countries in lockdown for the foreseeable future. It is this scenario, of course, that would have the largest economic impact. And it is this scenario that we are striving to protect against with our defensive portfolio positioning.

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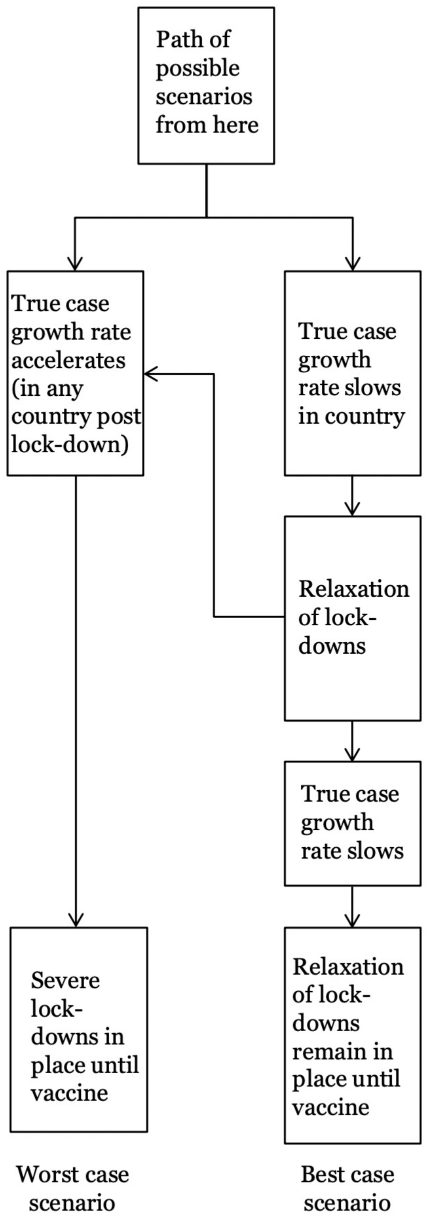
**Simplified scenario tree**




Source: MGI

We certainly do not wish to find ourselves in the worst-case scenario. Though if we do, investors should take (modest) comfort in two things: (i) very defensive portfolio positioning for preserving capital as this scenario unfolds, and (ii) after we pass through this period there will be once-in-a-generation investment opportunities that present themselves and the portfolio will be positioned to take advantage of them.

We believe one such opportunity will likely be Prudential Plc (LSE: PRU), the 170-year old life insurer that has built up one of the most valuable franchises in Asia. In the case study that follows, Daniel Wu articulates why Prudential is a very high-quality business that remains extraordinarily undervalued today.

CASE STUDY: PRUDENTIAL PLC

Prudential plc is a UK-listed multinational life insurance company with origins tracing back to 1848 when it was founded in London to offer life assurance and loans to the middle class. Nearly two centuries later, the company offers life insurance, savings products and asset management to over 20 million customers across Asia, the U.S. and Africa.

In October 2019, Prudential demerged its UK and European life and asset management businesses into a separate listed entity, M&G plc, retaining the fast-growing Asian life insurance operations and a large variable annuities business in the U.S. This case study will focus on Prudential's Asian business, which we believe is the key driver of value for the stock, especially in the current low rate and volatile environment. For context, the U.S. business, Jackson National Life, only contributes 20 per cent of new business profit and 30 per cent of group embedded value (a life insurance concept we will explore later).

**Prudential Corporation Asia**

Despite its English provenance, Prudential's present value and future growth is dominated by its Asian business, Prudential Corporation Asia ("PCA"), which is one of the leading life insurers in the Pan-Asian region. PCA's extensive 90-year history in Asia has allowed it to build a formidable moat around this rapidly growing region. Given the complexity of life insurance operations, it would take competitors years if not decades to acquire the regulatory licences, develop the distribution partnerships, deploy the technology and most importantly build the brand trust to compete effectively with PCA.

PCA has a top 3 position measured by new business sales in 9 of the 13 life insurance markets it operates in, including the key market of Hong Kong which taps into the demand from Mainland Chinese consumers. This strong position across multiple markets has two key advantages. Firstly, the fast-growing emerging South East Asian markets help diversify the risk of a slowdown in more developed markets, as was the case in Hong Kong during the political protests through the second half of 2019. This diversification builds resiliency into PCA's new business sales and profits.

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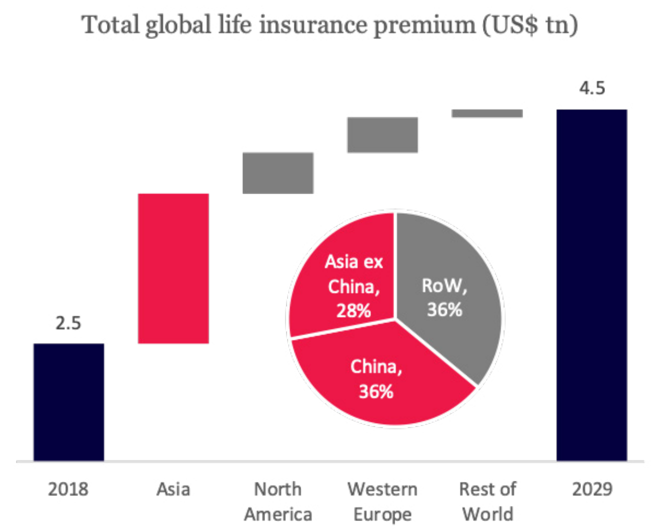
Secondly, and more importantly, the leadership position in these markets gives PCA significant exposure to the growth of global life insurance premiums over the next decade, almost two-thirds of which is expected to originate in Asia:

**Future sources of growth**



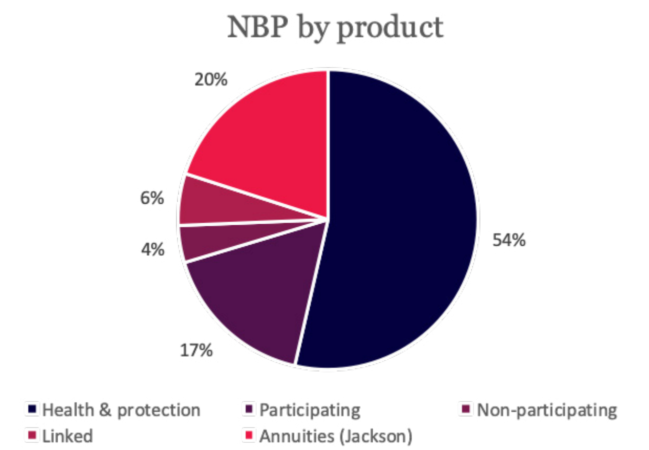

*Source: Allianz Global Insurance Market at a crossroads, May 2019*

Driving this disproportional growth of life insurance premiums in Asia is a rapidly aging population and low insurance penetration. The population over 65 years of age in Asia is expected to almost triple between 2015 and 2050 to 696 million. Due to limited social welfare provisions, these people have a growing need for retirement income. Yet life insurance penetration[1] is still low at 2.7 per cent of GDP compared to 7.5 per cent in the UK and 4.3 per cent for the group of advanced economies across North America, Europe and Asia Pacific. Furthermore, a health protection gap of $1.8 trillion representing out of pocket healthcare expenditure of 43 per cent[2] compared to just 11 per cent in the U.S. and 15 per cent in the UK suggests favourable demand for highly profitable health and protection policies.

In terms of profitability, health and protection products are as much as 4 to 6 times more profitable than traditional participating or unit-linked life insurance products. More than half of Prudential's life insurance new business profit comes from health and protection products, which indicates high quality underwriting practices and should drive higher new business profit margins.

These products are also far less sensitive to interest rates than participating products and the variable annuities sold by the US-based Jackson National Life, which is an important consideration in the current low interest rate environment.

**Products**




*Source: Company filings*

An undervalued business

Due to the long-term nature of life insurance contracts where profits are usually "locked in" when a policy is written, investors typically adopt an embedded value ("EV") framework rather than IFRS earnings when valuing life insurers. In layman's terms, EV is the present value of expected future profit generation from insurance policies written in the past plus shareholders' equity – that is to say, if an insurer were to stop writing new business altogether, EV would be the expected liquidation value of the business.

Prudential reported an EV per share of GBp 1,700 in 2019, of which GBp 1,200 was attributable to PCA and GBp 500 to Jackson. Given Prudential's consistent mid-teens operating return on EV and 17 per cent EV CAGR since 2012 – that is, new business contributed 17 per cent per year to EV – one would reasonably expect Prudential to be trading north of GBp 1,700 per share. However, at the current share price of GBp 920[3], Prudential is trading at just over half of its liquidation value despite nearly doubling said liquidation value every four and a half years! In fact, an investor today can buy the high quality PCA business at 75 cents per dollar (of liquidation value) and receive the U.S. business for free.

1 Insurance penetration calculated as life insurance premiums as a % of GDP. Swiss Re Sigma 2017.
2 WHO Global Health Observatory data repository. % of total health expenditure.
3 As at 3 April 2020.

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While there are certainly some external events pressuring Prudential's share price, such as the Hong Kong protests and the Coronavirus pandemic, we believe the current discount to liquidation value (let alone fair value) is too great for long-term investors to ignore. We expect the combination of a rapidly aging Asian population, an underinsured middle class and a wide health protection gap to drive profitable life insurance adoption for years to come, and Prudential is one of the best-positioned life insurers to take advantage of this structural growth. The Montaka funds own Prudential because we believe that not only does the company own some of the highest quality insurance assets globally, it is also significantly undervalued.

* * *

In closing, we acknowledge that many investors will be disappointed with our short-term performance – and we are too. While we understand that the uncertainty and strangeness of a crisis may bring shorter-term performance into focus, we instead encourage our investors to remain focused on the prospects that are emerging for very attractive long-term returns. We believe that an important part of managing this crisis is preparing to take advantage of the extraordinary opportunities that will surface on the other side and staying patient in the meantime. We continue to execute our process every day in service of that objective.

Without a doubt, the past six weeks have been stressful for our clients as well as our team, and we would like to thank our investors for the incredible support you have shown us in the face of this stress. Your actions and feedback have given us hope that we will come out of this turbulent time having forged a closer bond with the people whose capital we seek to preserve and grow.

Finally, we wish you all strong physical and mental health. Every one of us will likely know someone profoundly affected by this virus, and we will be keeping our investors, their families, and our global community in our thoughts as we navigate this challenging period. We will continue to keep you informed of our thought process as best we can, and we encourage you to reach out with any ongoing questions, thoughts or feedback as we take this journey together.

Sincerely,

Andrew Macken

Montaka Global Access Fund

Montaka Global Investments

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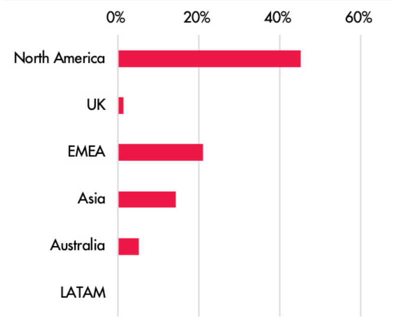
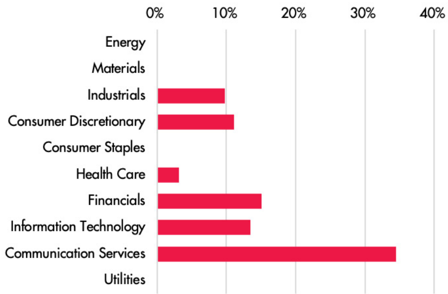
## LONG PORTFOLIO (31 March 2020)

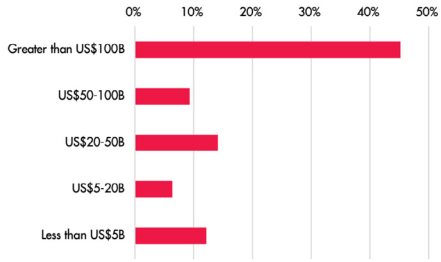
### GEOGRAPHIC EXPOSURE
(Country of domicile)




### INDUSTRY EXPOSURE

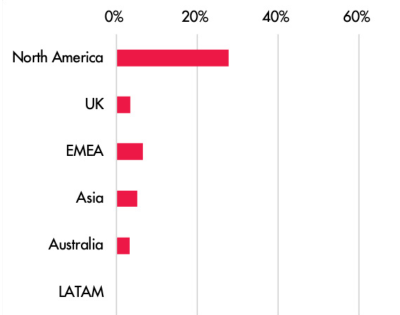



### MARKET CAP EXPOSURE

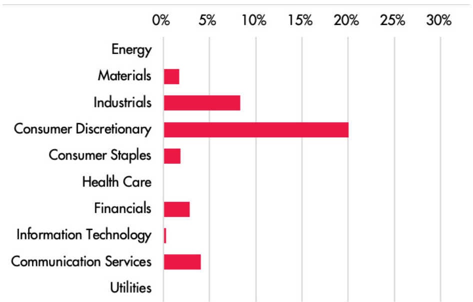



## SHORT PORTFOLIO (as at 31 March 2020)

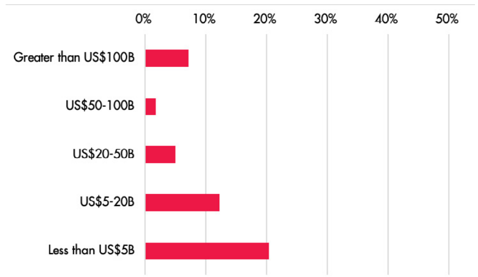
### GEOGRAPHIC EXPOSURE
(Country of domicile)




### INDUSTRY EXPOSURE




### MARKET CAP EXPOSURE




Note: exposures shown as % of NAV

## INVESTMENT MANAGER

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