MONTAKA GLOBAL ACCESS FUND

MONTAKA

QUARTERLY LETTER

SEPTEMBER 2018

UNIT PRICE [1]
$1.0865

FUND COMMENTARY

In the month of September, the Montaka Global Access Fund (the Fund) declined by 1.77 per cent, net of fees. Over the September quarter, the Fund returned negative 0.56 per cent, net of fees. Since inception, the Fund has increased by 18.63 per cent, net of fees.

The world continued to evolve quickly during the September quarter. The Trump Administration continued to drastically redefine the US relationship with allies and rivals alike. The rapidly deteriorating relationship between the US and China is perhaps the most significant instance of this – and has materially impacted global equity markets during the quarter.

As articulated by Chris Johnson from the Center for Strategic & International Studies and former China analyst for the CIA, China is now being viewed by the US through the lens of a "new Holy Trinity" which is to say that China: (i) is a revisionist power; (ii) practices predatory economics; and (iii) is a strategic competitor of the US[1]. This is a new perception in the US and it likely has meaningful long-term consequences for the world.

In August, Long Guoqiang, vice-president of the State Council's Development Research Centre, effectively concurred with this view when he commented in People's Daily that: "With the US labelling China as a strategic rival, Sino-US relations will experience a deep structural change[2]."

FUND PERFORMANCE

PERFORMANCE ATTRIBUTION[1]* (%)

	September 2018
Long portfolio contribution	(1.78)
Short portfolio contribution	0.55
Change in AUD/USD	(0.54)
Net return	(1.77)
Since inception[2]	18.63

EXPOSURES (as at 30 September 2018)

	% of NAV
Long exposure	82.0
Less: short exposure	(42.1)
Net market exposure	39.9

POSITION METRICS (as at 30 September 2018)

	Long Portfolio	Short Portfolio
Number of positions	20	32
Largest position size	6.2	2.4
Smallest position size	1.8	0.5
Average position size	4.1	1.3

Note: sizes shown as % of NAV

TOP 10 LONG POSITIONS (as at 30 September 2018)

		% of NAV			% of NAV
1	St James's Place	6.2	6	Rheinmetall	4.9
2	Vivendi	5.9	7	Insperity	4.9
3	Wells Fargo	5.6	8	REA Group	4.7
4	Facebook	5.6	9	Microsoft	4.7
5	Swedbank	5.2	10	Travelers Companies	4.5
Total top 10 long positions					52.1

FUND SIZE (NAV) ($M) (as at 30 September 2018)

Montaka Global Fund	196.7
of which: Montaka Global Access Fund	75.4

PERFORMANCE (%)	1M	3M	12M	2 Yr pa	COMPOUNDED ANNUAL RETURN SINCE INCEPTION	SINCE INCEPTION
Fund (AUD)[2]	**(1.8)**	**(0.6)**	**14.2**	**12.8**	**6.0**	**18.6**
Underlying Fund (AUD)[4]	(1.8)	(0.6)	14.2	12.8	9.9	36.0
Average Net Market Exposure	40	39	43	46	46	46
Global Market (AUD)[2,5]	0.5	7.2	20.6	17.9	10.5	33.7
Average Net Market Exposure[3]	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 and 7.4407 cents 30/06/2018
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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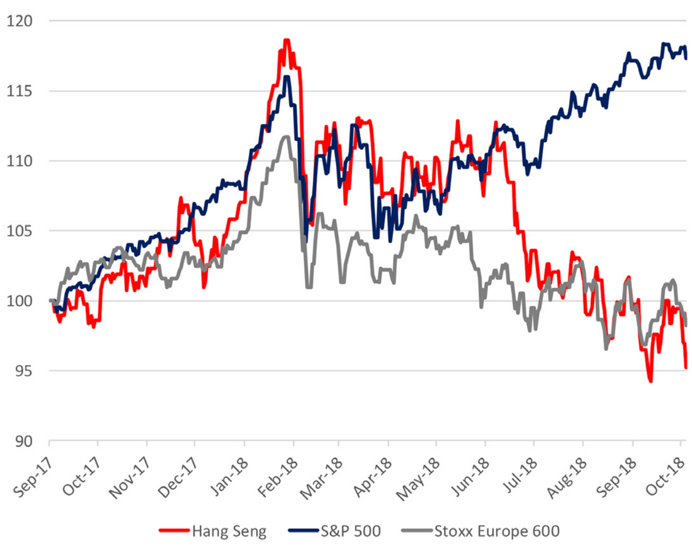
Given this dynamic, President Trump's well-publicised trade measures that have been roiling global markets are unlikely to be the only policies targeting China over the medium term. As Henry Kissinger told the FT in July[3]: "I think we are in a very, very grave period for the world," in what was perhaps an ominous warning to which we should all take heed.

On the economic front, the US economy continues to power on with strength not observed for more than a decade. As such, the Federal Open Market Committee continued to raise the US federal funds rate; and we expect further rate rises to come.

During the quarter, the US dollar continued to remain strong; with weakness observed in the Renminbi and the Pound Sterling. We avoided substantially all of this weakness with targeted hedging of our underlying exposures to these two currencies over the period. The Fund's largest currency exposures remain the US dollar and the Euro.

In terms of stock performance, our September quarter was characterised by reasonable performance in Montaka's short portfolio; with underperformance in Montaka's long portfolio. We attribute this underperformance primarily to the significant "rotation" in global equity markets that has taken place over recent months, as illustrated by the chart below.

Comparison of Global Equity Indices (100 = September 2017)



Source: Bloomberg; MGI

ASSESSING THE SITUATION

Market rotations include indiscriminate selling and buying of large groups of stocks based on specific factors, such as geography or industry. They are often temporary in nature because indiscriminate selling and buying of stocks typically result in stock mispricings which reverse subsequently over time. That said, a rotation with any degree of persistency needs to be managed carefully by the portfolio manager.

Our assessment of the drivers of this rotation can be simplified as follows:

- President Trump's escalating trade war – and the ongoing deterioration of the US-China relationship – has increased the risk aversion of global investors, especially with respect to Asian and European equities.
- US monetary policy, heightened risk aversion and the expectation of a declining US trade deficit are all pushing the US dollar higher. This, in turn, is wreaking havoc in some emerging market economies – especially those which have significant outstanding US dollar-denominated borrowings.

In terms of the persistency of these drivers, our assessment is that President Trump has a political incentive to continue to act aggressively, at least until the Midterm Elections on November 6, and possibly beyond. Such tough action resonates well with his political base. Similarly, Chinese and European policymakers have an incentive to not back down prior to the Midterms on the basis that Democrats have a meaningful chance of taking back control of the House of Representatives. Such a win for the Democrats may constrain President's Trump's future protectionist trade measures.

That said, there is a world in which President Trump's aggressive behaviour towards China specifically persists for a much longer period of time – and potentially for the remainder of his Presidency. The basis for this scenario is two-fold: (i) Trump has effected most of his trade measures to date via Executive Orders which do not require approval from Congress (and we note that any future law proposed by a Democratically-controlled Congress could be vetoed by the President); and (ii) there is genuine bipartisan support in the US for tough action on China and a reset of the overall relationship.

On this basis, the Montaka research team has assessed that the current rotation will likely persist at least until November and possibly for much longer.

[1] (Intelligence Matters) Chris Johnson on the Future of the US-China Relationship, October 2018
[2] (SCMP) Expect 'deep structural change' in ties between China and US, senior adviser says, August 2018
[3] (FT) Henry Kissinger: 'We are in a very, very grave period', July 2018

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TAKING ACTION

In the long-run, this rotation – like all rotations – will be temporary and will ultimately reverse as mispriced stocks revert to fair pricings. Our assessment of the persistency of this rotation (at least months and possibly years), however, is long enough to warrant some degree of short-term risk management.

As such, on the basis of Montaka's pre-existing positioning and the team's analysis of the drivers and persistency of the current rotation, the following portfolio changes were made. The major changes can be summarised as follows:

- Chinese exposure was materially reduced; and US exposure was increased, primarily through the reduction of some US-based shorts.
- These changes resulted in a reduction in gross exposure by 20 per cent of NAV; while the net exposure remained approximately the same.

Montaka (% of NAV)			
Country of domicile	31/08/2018	30/09/2018	Change
Long exposure			
US	40.9%	37.1%	(3.7%)
China	19.7%	10.3%	(9.4%)
Japan	0.0%	0.0%	0.0%
UK/EU	26.1%	25.4%	(0.7%)
Australia	4.9%	9.1%	4.2%
Subtotal	91.6%	82.0%	(9.6%)
Short exposure			
US	(32.9%)	(24.3%)	8.6%
China	0.0%	0.0%	0.0%
Japan	(1.5%)	(1.7%)	(0.1%)
UK/EU	(11.8%)	(8.4%)	3.4%
Australia	(6.1%)	(7.7%)	(1.6%)
Subtotal	(52.3%)	(42.1%)	10.2%
Net exposure			
US	8.0%	12.8%	4.8%
China	19.7%	10.3%	(9.4%)
Japan	(1.5%)	(1.7%)	(0.1%)
UK/EU	14.3%	17.1%	2.7%
Australia	(1.2%)	1.4%	2.6%
Subtotal	39.3%	39.9%	0.6%
Gross exposure			
US	73.8%	61.5%	(12.3%)
China	19.7%	10.3%	(9.4%)
Japan	1.5%	1.7%	0.1%
UK/EU	37.9%	33.8%	(4.1%)
Australia	11.0%	16.8%	5.8%
Subtotal	143.9%	124.0%	(19.8%)

Source: MGI

We believe this action was decisive and will serve to reduce any pain from an extended market rotation over the coming months (and possibly years). At the same time, we acknowledge the inherent unpredictability of the timing of any potential reversal and so continue to hold on to some of our existing exposures which we believe will be valuable to our investors over the long term.

The rationale of this action can be simplified as follows: by reducing exposure today, we help preserve the downside should this rotation persist for an extended period of time; and we create an opportunity to be able to add back this exposure in the future at a potentially more favourable price point.

Managing risk within the Montaka portfolio by taking actions like those described above is a critical part of our responsibility as stewards of our investors' capital. But these actions should not be over-emphasized in the minds of our readers. The vast majority of the waking hours of the Montaka research team are spent analysing individual businesses and industries which can lead to the identification of mispriced equities.

This quarter, Chris Demasi illustrates the type of analysis we perform and the insights we uncover to identify opportunities. As Chris shows, we believe Campbell Soup has been, and continues to remain, overvalued with asymmetric risks to the downside. As such, Campbell Soup continues to find itself in Montaka's short portfolio.

CASE STUDY: CAMPBELL SOUP

Just over two years ago, Montaka initiated a short position in Campbell Soup (NYSE: CPB). At the time, we applied our unique short-side framework to determine that Campbell's would likely be a great short. While that has certainly been the case we believe that Campbell's is still a great short today. Campbell's ticks all four of our proprietary shorting criteria, and we will take each one in turn.

Montaka Criteria	Drivers	
Structural Themes	• Consumer trends – fresh/healthy food, ecommerce/social • Competition – private label, small brands	✓
Divergent Expectations	• Organic sales are declining, cost pressures are building, profits have peaked • BUT market expectations are optimistic: LSD growth, expanding profit margins	✓
Asymmetries	• Levered 5x debt/EBITDA • Activism/acquisition premium	✓
Misperceptions	• Acquisitions mask declining organic sales and lower core profitability	✓

Source: MGI

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Soup in decline

Based in Camden, New Jersey, Campbell Soup Company is a global leader in the branded consumer packaged food industry, with around US$10 billion in annual sales, and the manufacturer of the iconic canned soup. Even though Campbell's has branched out into vegetable drinks and snacks, the soup business still generates up to half the company's earnings.

Unfortunately, soup sales have been declining in recent years. Consumers have turned away from packaged food, filled with unhealthy ingredients and preservatives, and have turned to fresh and organic alternatives instead. Even the traditional steel cans have been a turn-off. While the volume of condensed and ready-to-serve soup were down 8 per cent and 5 per cent, respectively, in the last 12 months, the story for Campbell's is worse still.

Campbell's often commanded 60 per cent or more of US soup sales. In years gone by, Campbell's used its heft to lock up shelf space with brick-and-mortar grocers, and its multi-billion-dollar advertising campaigns guaranteed the best consumer reach on billboards and TV commercials. But this dominant market position has been disrupted.

Today smaller brands no longer fight for finite shelf space – Amazon provides limitless digital shelf space online – and they cost-effectively engage consumers – with targeted advertising on Facebook. At the same time, supermarkets have allocated more shelf space to their own private label products. Campbell's has shed over two percentage points of market share in the past year alone. In the most recent quarter, Campbell's reported its US soup sales dived 14 per cent. Clearly Campbell's is in ***structural decline***.

Paradoxically high expectations

Even while operating conditions for Campbell's have been worsening, the market has continued to price in a return to growth and improving profitability for over two years now. Campbell's business keeps declining, but the market never resets its expectations down quick enough, so the stock remains overvalued.

Today Campbell's stock faces a paradox of sorts. On the one hand, if Campbell's has any chance of reinvigorating top line growth, its management team will need to reverse the cost cuts of the last decade and increase investment in marketing and innovation. Such a plan would substitute uncertain future sales growth with a certain reduction in current profit margins. On the other hand, if Campbell's management wants to continue to defend profit margins by cutting costs or pushing prices, it is difficult to see how the company will grow.

To us it can be summed up simply: either Campbell's can have growth or margin, but it can't have both – yet that is exactly what is required by the market at the current share price! We hold a differentiated view to the market, which means the stock satisfies the ***divergent expectations*** criterion.

Asymmetries building

As Campbell's story has played out, it has also met the ***asymmetries*** condition – in two separate ways.

Campbell's sought to diversify away from the soup business with an acquisition strategy, including Pacific Foods bought for US$700 million in 2017, and Snyder's Lance – itself a combination of two savoury snacks businesses – bought for US$6 billion in 2018. To fund these deals Campbell's borrowed significant sums and the debt load swelled. Campbell's has US$10 billion of net debt today, up from US$2.5 billion in 2012. The financial leverage is now more than five times earnings.

This level of debt presents a meaningful risk to the value of Campbell's stock. As earnings decline, and the value of the firm falls, the value of the equity falls even quicker. The situation could become more dangerous. If current trends persist Campbell's may well be on its way to bankruptcy. Yet the debt is not the only asymmetric risk percolating.

Over the last couple months, Campbell's has become the target of an activism campaign. Dan Loeb's hedge fund, Third Point, has accused the board of overseeing mismanagement of the company and shareholder value-destruction over two decades. He has proposed a slate of a dozen new directors and has also demanded that management pursue strategic alternatives, including a sale of the entire company. When an activist hedge fund comes knocking, stock prices tend to run up, especially if the investor is calling for a sale of the company. This seems to be what has happened at Campbell's.

After trading at lows in June of around US$32/share, Campbell's stock traded near US$42/share after Third Point's involvement became public. The consumer staples sector also rallied during this time, up by around 10 per cent, but Campbell's share price gain was nearer 25 per cent. Even after falling back to US$37/share, it's not unreasonable to assert that Campbell's stock is still pricing in some bid premium. But there's a rub.

The company's charter requires two-thirds of shareholders to approve a sale of the company. But together Bennett Dorrance and Mary Alice Malone, grandson and granddaughter of the inventor of condensed soup and original owner of Campbell's, own one-third of the shares. The stake is enough to block a sale, and they have a long history of wanting to keep the business in the family. The chance of them agreeing to a deal looks slim. If the prospect of the deal were to fall away, then the stock would lose its bid premium and the share price would drop.

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Misperceived performance

In some small way the current management team of Campbell's are trying to lessen the burden of the debt-funded acquisitions by seeking a sale of two divisions. Yet in doing so, they may just catalyse a ***misperception***. Until now Campbell's has been able to report revenue growth and cost-outs, due to the addition of new businesses and cost synergies. But with the recently- announced sale of two divisions management may have pressed stop, or even rewind, on the deal music. And the true underlying decline in sales and stagnation in profitability should be revealed.

Campbell Soup share price performance

Source: Bloomberg

Still a Great Short

Since Montaka has been short, Campbell's **stock is down by around 40 per cent**. This has been a very pleasing result in an absolute sense. In a relative sense the result is even better. Over this period **global equities are up about 40 per cent, representing almost 80 per cent** "short alpha" so far. But more importantly, we think the case for being short Campbell's is still attractive today.

* * *

As we stand here today and look to the future, we find ourselves back in the familiar position of seeing a wide range of possible future outcomes. And this increased degree of uncertainty makes the life of the prudent investor significantly more difficult.

As the saying goes: the nature of risk is that, while many things can happen, only one thing will happen. At Montaka, we agonize over the construction of our portfolio to try to ensure, as best we can, that the portfolio will be able to deal with all possible scenarios. Naturally, when the range of possible scenarios is wider, portfolio construction becomes more difficult.

At the beginning of this calendar year, we identified two key risks that would likely have a material impact on global equity markets in 2018. These were: (i) the deteriorating relationship between the US and China; and (ii) tightening US monetary policy in the form of rising interest rates and bond yields.

The former risk has proved to be more severe than most expected, as we described above; while the latter is also gathering steam. At the time of writing this letter, the US 10YR government bond yield hit a seven-year high. Meanwhile, we note that Japan's 10YR is near a three-year high; and yields in China, UK and Europe have all remained firm of late.

We believe these two risks will continue to be significant for global equity investors going forward. We also believe it is now time to add a third key risk to this list: the potential for a disorderly Brexit, in March 2019. Our observation with respect to Brexit is a simple one: the negotiations between the UK and the EU have been largely dysfunctional and our perception is that the UK government is severely underprepared for the impending exit. Given the lack of a "play book" for such a significant geopolitical event involving a US$2.7 trillion economy, a disorderly exit would likely be a globally significant event.

And despite these identified downside risks, there is cause for optimism. The rotation and volatility we are seeing in global equity markets are resulting in an opportunity set that, we believe, has not been this mispriced in many years. And to the extent the current madness continues, the opportunity set will likely only become more mispriced.

This is wonderful news for the patient Montaka investor. Mispriced equities are the fundamental ingredient to stock-specific value-add (or "alpha", as it is commonly known). We are very much looking forward to taking advantage of these opportunities and converting them into returns for our investors over the quarters and years ahead.

Thank you for the ongoing trust you have placed in the entire Montaka team to preserve and grow your wealth. We invest along side you in the fund. And we continue to work tirelessly to deliver you strong risk-adjusted returns and a positive and educational investor experience.

Sincerely,

Andrew Macken

Chief Investment Officer

MONTAKA
GLOBAL ACCESS FUND

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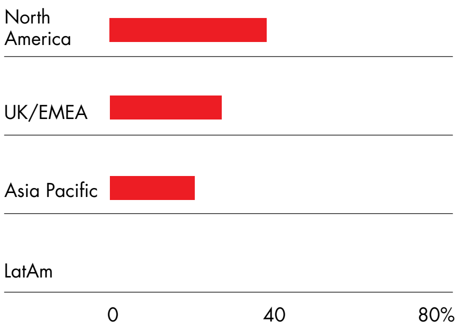
QUARTERLY LETTER

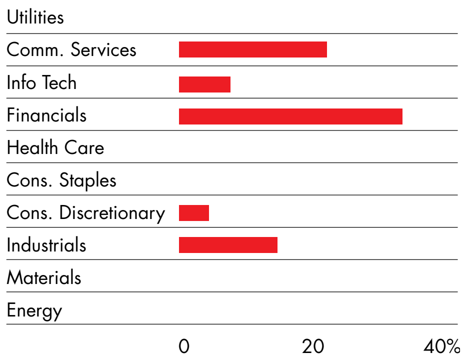
SEPTEMBER 2018

LONG PORTFOLIO (as at 30 September 2018)

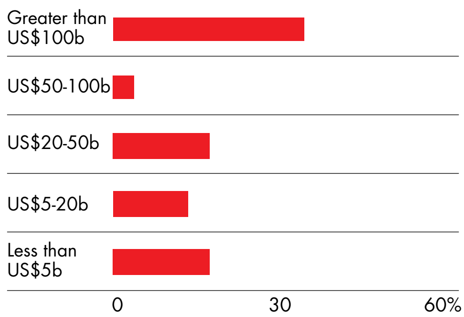
GEOGRAPHIC EXPOSURE (Country of domicile)



INDUSTRY EXPOSURE

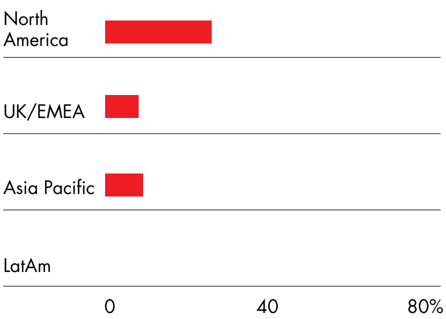


MARKET CAP EXPOSURE



SHORT PORTFOLIO (as at 30 September 2018)

GEOGRAPHIC EXPOSURE (Country of domicile)



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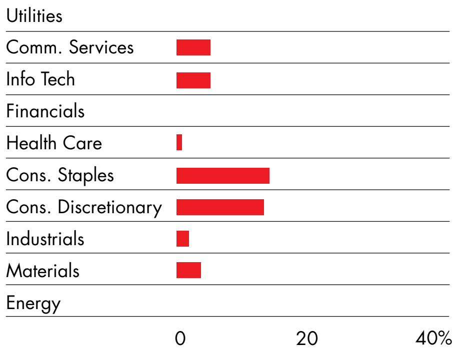
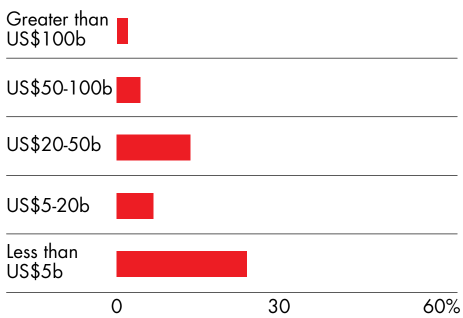


MARKET CAP EXPOSURE



Note: exposures shown as % of NAV

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DISCLAIMER

#Fund performance is calculated after fees and costs, including the investment management fee and performance fee. All returns are on a pre-tax basis.

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