



MONTGOMERY GLOBAL FUND

INVESTMENT REPORT & FACT SHEET

FUND OVERVIEW

The Montgomery Global Fund employs a highly disciplined, bottom-up, value style and typically invests in 15 to 30 high conviction stocks listed on major global stock exchanges. The focus of The Fund is on investing in what Montgomery Global regards as high quality businesses with attractive prospects trading at a discount to their estimated intrinsic value.

The Fund has the flexibility to retain a reasonable level of cash, with a "soft" 30 per cent limit. The Fund will generally be currency unhedged but we can put in place strategies aimed at protecting investor capital against currency fluctuations if we predict material upside to the Australian dollar.

The Fund aims to deliver superior positive returns when suitable investment opportunities are abundant, and to preserve capital through cash allocations when an insufficient number of company names are appealing.

FUND FACTS

INVESTMENT MANAGER

Montgomery Global Investment Management Pty Ltd

OBJECTIVE

The Montgomery Global Fund aims to outperform the index over a rolling 5-year period.

BENCHMARK

MSCI World Net Total Return Index, in Australian dollars.

FUND CONSTRUCTION

The Fund will typically invest in a portfolio of 15-30 high-conviction stocks listed on the major global stock exchanges. Cash typically ranges from 0%-30%, but can be exceeded in certain situations.

APIR

FHT0036AU

RECOMMENDED INVESTMENT TIMEFRAME

5 years

MINIMUM INITIAL INVESTMENT

\$25,000

INCEPTION DATE

1 JULY 2015

FUND SIZE

\$164.3M

MANAGEMENT FEE

1.32% per annum, inclusive of GST/ITC.

PERFORMANCE FEES

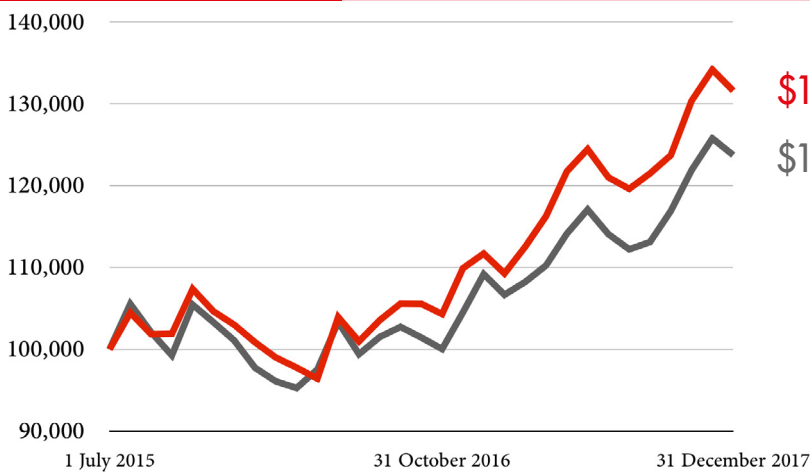
15.38% of the total return of The Fund that is in excess of its Benchmark. No performance fee is payable until any previous periods of underperformance has been made up.

APPLICATION & REDEMPTION PRICES

montinvest.com/mgf

PERFORMANCE GRAPH

■ Montgomery Global Fund ■ MSCI World Net Total Return Index



CONTACT DETAILS

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PORTFOLIO PERFORMANCE

(to 31 December 2017, after all fees)

	INCOME	CAPITAL GROWTH	MONTGOMERY GLOBAL FUND	MSCI WORLD NET TOTAL RETURN INDEX ¹	OUT/UNDER PERFORMANCE
1 month	0.00%	-1.92%	-1.92%	-1.63%	-0.29%
3 months	0.00%	6.37%	6.37%	5.84%	0.53%
6 months	0.00%	8.75%	8.75%	8.48%	0.28%
12 months	10.83%	6.98%	17.81%	13.32%	4.50%
2 years (p.a)	5.71%	7.32%	13.03%	10.64%	2.40%
Since inception ²	12.10%	19.51%	31.61%	23.75%	7.86%
Compound annual return (since inception) ²	4.68%	6.94%	11.61%	8.90%	2.72%

1) In Australian dollars

2) Inception: 1 July 2015



FUND COMMENTARY

In the month of December, the Montgomery Global Fund declined by 1.92 per cent, net of fees. This brought the quarterly return for the fourth calendar quarter of 2017 to 6.37 per cent, net of fees. The calendar 2017 return was 17.81 per cent, net of fees, delivered with an average cash weighting of 22 per cent (or a 78 per cent net market exposure). By comparison the MSCI World Total Return Index in Australian dollar terms (the Global Market) delivered 13.32 per cent over the calendar year, but with 100 per cent net market exposure.

Since inception, the Fund has delivered a return of 31.61 per cent, net of fees. By comparison, the Global Market delivered 23.75 per cent over the same period.

Calendar 2017 can be characterised as a year of strong and stable returns for global equity investors. First, the year delivered strong annual returns with the MSCI World Total Return Index increasing by 22.4 per cent (in US dollar terms).

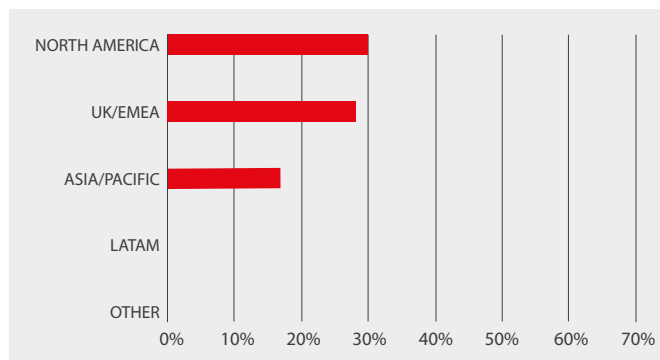
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TOP COMPLETED HOLDINGS* (TCH) (at 31 December 2017, out of 22 holdings)

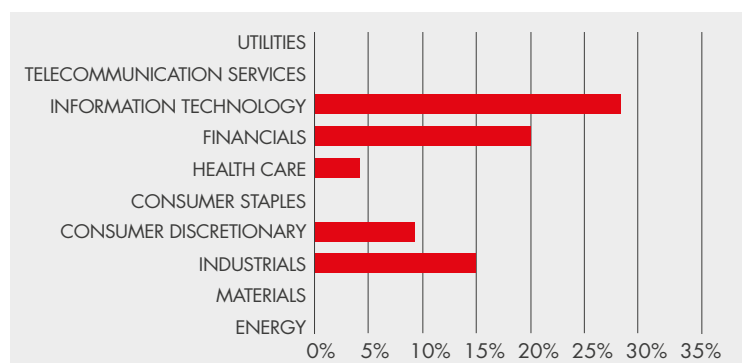
COMPANY NAME	COUNTRY OF DOMICILE	MARKET CAP (\$USDM)	WEIGHT (%)
St James's Place	GB	8,763	5.7
Union Pacific	US	105,559	4.6
Rea Group	AU	7,881	4.5
Facebook	US	514,985	4.4
Insperty	US	2,391	4.3
NetEnt	SE	1,658	4.2
Apple	US	860,882	4.0
Jupiter Fund	GB	3,886	3.9
Alibaba	CN	441,620	3.7
Essilor	FR	30,229	3.5
PORTFOLIO MEDIAN		60,187	3.4
Total equity weighting			74.9
Total cash weighting			25.1

*Top Completed Holdings are businesses we own but are not actively buying or selling at the time of writing.

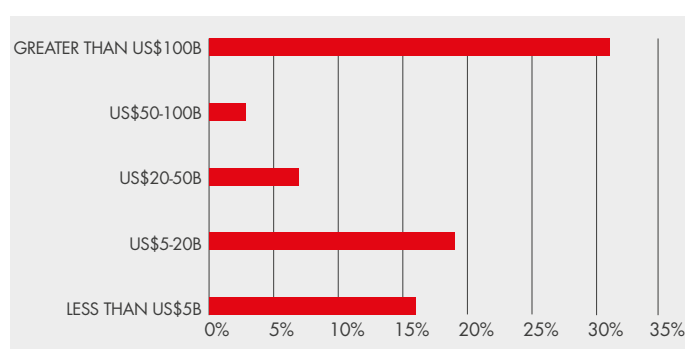
GEOGRAPHIC - COUNTRY OF DOMICILE



GICS SECTOR INDUSTRY EXPOSURE



MARKET CAPITALISATION EXPOSURE

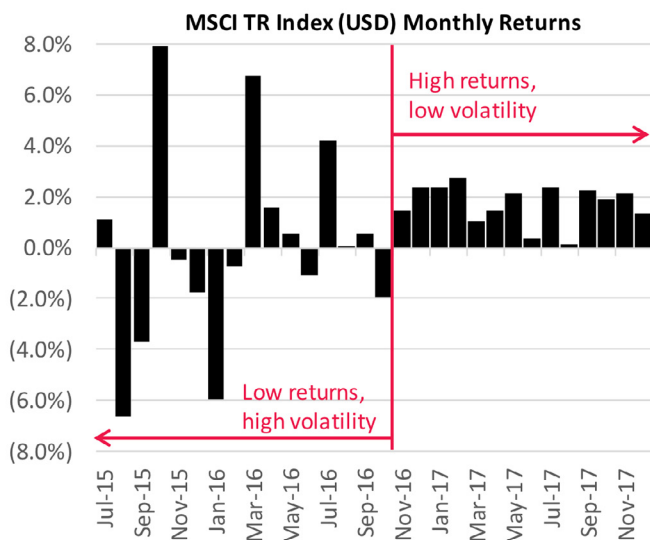


PLATFORMS WE ARE ON: Netwealth IDPS = Netwealth Super = BT Panorama = BT Wrap = Powerwrap = Macquarie Wrap = HUB24 = Asgard

#Portfolio Performance is calculated after fees and costs, including the investment management fee and performance fee, but excludes the buy/sell spread. All returns are on a pre-tax basis. This report was prepared by Montgomery Global Investment Management Pty Ltd, (ACN 604 878 533) [CAR] #001 007 050 (Montgomery) the investment manager of the Montgomery Global Fund. The responsible entity of the Fund is Fundhost Limited (ABN 69 092 517 087) (AFSL No: 233 045) (Fundhost). This document has been prepared for the purpose of providing general information, without taking account your particular objectives, financial circumstances or needs. You should obtain and consider a copy of the Product Disclosure Statement (PDS) relating to the Fund before making a decision to invest. While the information in this document has been prepared with all reasonable care, neither Fundhost nor Montgomery makes any representation or warranty as to the accuracy or completeness of any statement in this document including any forecasts. Neither Fundhost nor Montgomery guarantees the performance of the Fund or the repayment of any investor's capital. To the extent permitted by law, neither Fundhost nor Montgomery, including their employees, consultants, advisers, officers or authorised representatives, are liable for any loss or damage arising as a result of reliance placed on the contents of this document. Past performance is not indicative of future performance.



Second, these global equity returns were delivered with unusually low volatility. Consider the chart below that illustrates the monthly returns of the global equity market since the Fund's inception. One can clearly observe a near-collapse in volatility from November 2016.



Source: Bloomberg

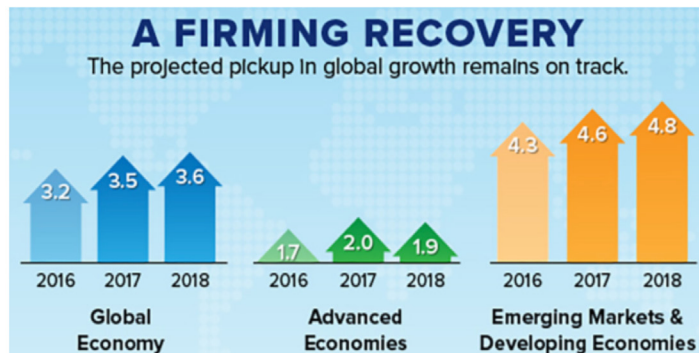
This extremely low level of variability in monthly returns was surprising to us, especially in light of 2017 being a year in which historians will look back and mark a genuine shift in the World Order. Significant changes in the domestic politics – and political systems – of the following nations were observed during the year:

- The United States – the election of President Trump and subsequent (ongoing) challenging of the nation's Constitution;
- Russia – the ongoing consolidation of power by President Putin and the rise in his outward brazen attacks on foreign democracies;
- China – the complete consolidation of power by an increasingly authoritarian President Xi;
- Saudi Arabia – the complete consolidation of power by an increasingly authoritarian MBS;
- North Korea – the attainment of an intercontinental ballistic missile capable of reaching the east coast of the United States; and
- The United Kingdom – the ongoing and muddled extrication from the European Union.

With so much geopolitical change occurring in one year, how was it that global equity markets were able to deliver an average 1.7 per cent monthly return, almost like clockwork?

In our view, this remarkable set of strong and stable monthly returns was the result of the Goldilocks economic conditions to which we have referred in the past. That is, global economic conditions have strengthened; while at the same time, global monetary conditions have remained highly-accommodative. For equities in general, this loosely translates into accelerating revenue and earnings growth, generated by assets funded with abundant and low-cost sources of capital. Good times, in other words.

Indeed, according to the IMF, 2017 marked the “broadest synchronised upswing the world economy has experienced in the last decade.”¹ And in our view, this is the most noteworthy theme of the year – in large part because very few would have predicted as such as recently as two years ago. But the combination of an enormous and globally coordinated economic stimulus in early 2016, combined with economically-friendly election results in the US and Europe, has led to a favourable set of global economic conditions, the likes of which we have not observed for some time.



Source: IMF

By way of example, consider the US economy, the world's largest and therefore one of significance to any global investor. We would argue that this economy is in the midst of a “triple dose” of economic stimulus:

1. Monetary conditions remain highly-accommodative with the target range of the Federal Funds Rate at 1.25-1.50 per cent; and Federal Reserve balance sheet assets at US\$4.5 trillion. Most would consider these levels to reflect “emergency settings” of monetary policy.
2. Since the beginning of the calendar year, the US Dollar Index – a trade-weighted average US dollar exchange rate – has declined by more than 10 per cent. This is an effective form of stimulus in the sense that US goods and services are 10 per cent cheaper in foreign currency terms – and therefore, in greater demand.
3. In the days prior to Christmas, President Trump signed into law the largest set of changes to the US tax code in more than three decades. Officially, this is a US\$1.5 trillion tax cut, though in practice, it will likely be a significantly larger cut to US tax revenues than this. From an economic perspective, this is a genuine and significant fiscal stimulus of the US economy in the short to medium term.

Many of the businesses we own on behalf of our investors are benefiting from the dynamics described above – both in the US and abroad more generally. We believe it is of critical importance to monitor closely the economic and geopolitical developments in the world. It is the interpretation of these observations that shape our judgement for the prospects of any potential investment opportunity.

¹ (IMF) A Firming Recovery, July 2017

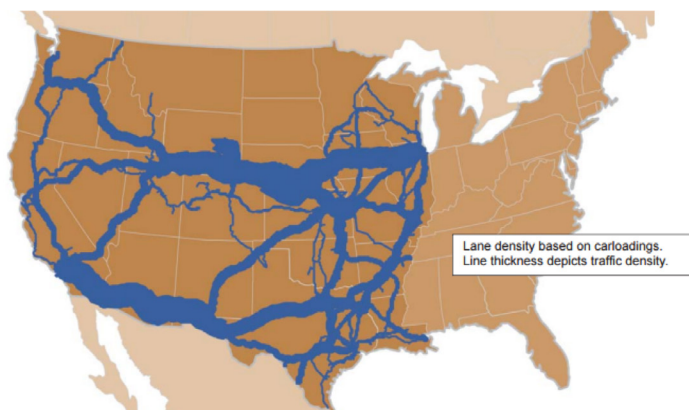
That said, what matters most for any business we own is what is already priced into the stock. And this forms the basis of our Expectations Framework for investing. Put simply, our framework leads us to: (i) identify the key value drivers of the business we are evaluating; (ii) reverse engineer what the current stock price is implying about the market's expectations for each of these value drivers; and (iii) evaluate the reasonableness, or otherwise, of said expectations.

If the market's expectations for the key value drivers of a business look reasonable, then there is no investment opportunity. No matter the quality of the business or the strength of any tailwind it might be experiencing: if the market has already priced in these factors, then there is no case for owning the stock. Only if the market's expectations are unreasonably conservative is there a case to own a stock.

By way of example, we examine a case study on Union Pacific (NYSE: UNP), one of the largest rail businesses in the US and a top 10 holding by the Fund. What is key in this example is not the quality of the business – though it is an extraordinarily high-quality business, but rather the market's expectations for this business, which we believe remain too conservative given the favourable conditions that this business will experience medium-term.

CASE STUDY: UNION PACIFIC

UNP is one of the few Class I rail business in the United States that links 23 states in the western two-thirds of the country with over 32,000 miles of rail. Shown below is the geographical footprint of UNP's business with the line thickness depicting traffic density. UNP owns a highly-critical segment of the US and global supply chain that is effectively impossible to recreate.



Source: UNP

In addition to owning a highly-valuable and scarce asset, UNP benefits from favourable competitive conditions. We view the market as being fairly "cooperative" and believe the industry has organised itself into three geographic duopolies:

- UNP and BNSF (owned by Berkshire Hathaway) in the mid-west;
- CSX and NSC in the east; and
- CP and CNR in the north (primarily Canada).

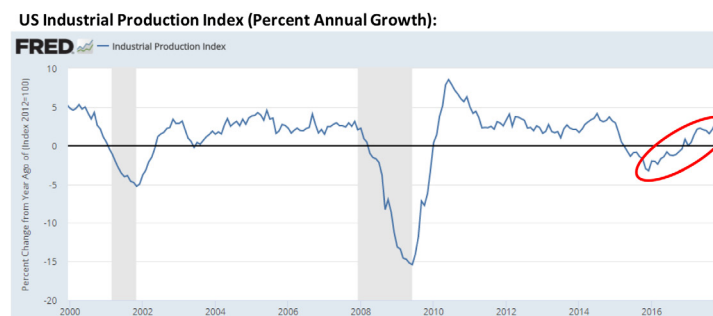
While competition is the friend of the consumer, cooperation is the friend of the shareholder.

UNP's demand drivers are diversified and resilient in nature. The table shown below illustrates the split of UNP's operating revenues.

Segment	Share of 3Q17 revenue
Agricultural	17%
Automotive	9%
Chemicals	17%
Coal	13%
Industrial Products	20%
Intermodal	18%
Other	7%
Subtotal	100%

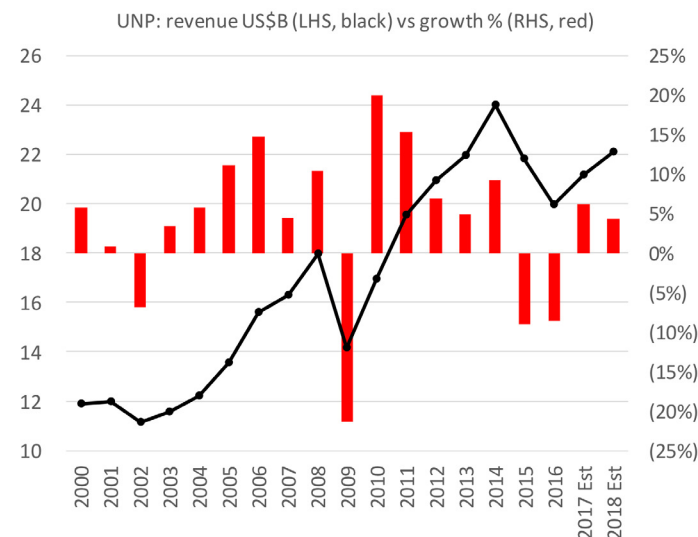
Source: UNP

Given this diversification, UNP's volume growth is substantially driven by the real industrial growth of the US economy in general. And this has been one aspect of the US economy that has been strengthening recently, as illustrated below.



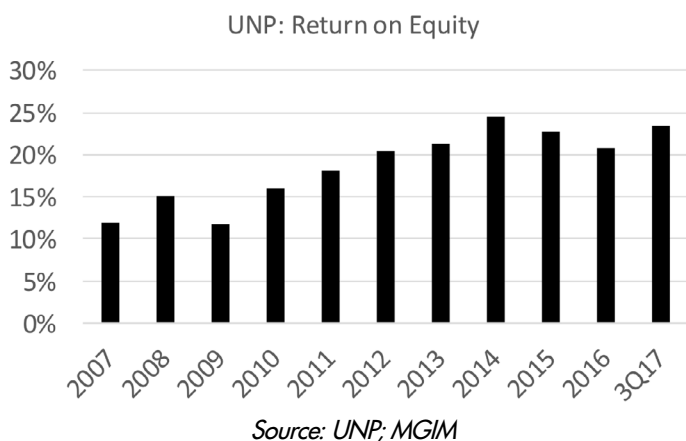
Source: FRED

Over the longer term, UNP's revenues have grown at an average rate of more than four per cent per annum, as illustrated in the chart below. This rate of growth appears sustainable and can be rationalised as, say 2.5 per cent of real industrial growth in the US, plus 1.5 per cent of pricing power – which itself is conservative, especially in light of the current truck driver shortage in the US which is driving up rates for the only real substitute to rails.

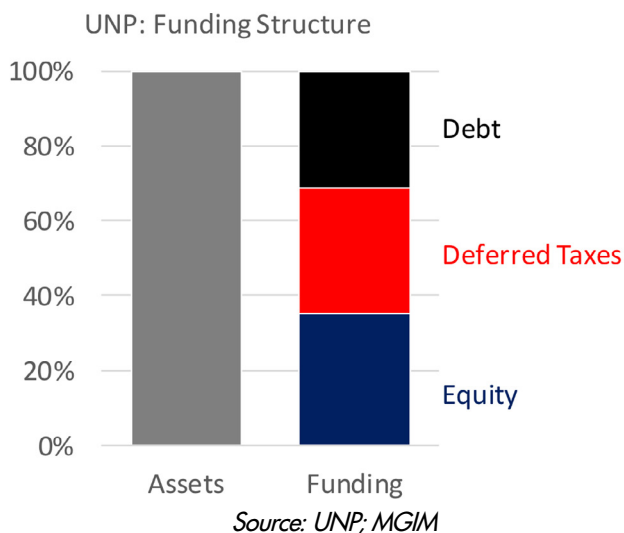


Source: Bloomberg

A study of UNP’s historical financials further supports our hypothesis that UNP is a very high-quality business. Cash flows have more than matched earnings; the balance sheet remains clean; and UNP’s post-tax returns generated on shareholder equity have remained north of 20 per cent for the last five years (as shown below). It should also be noted that UNP’s effective tax rate for reported earnings has historically averaged 38 per cent. Under the new Trump tax plan beginning 2018, this effective tax rate will nearly halve!



One underappreciated aspect of UNP’s business model is its very low-cost funding structure. As illustrated below, UNP’s business assets are funded in part by equity, debt and deferred tax liabilities (DTLs). These DTLs stem from timing differences between the taxes provisioned for financial reporting and the taxes actually paid as required under tax reporting. Economically, they are equivalent to an interest-free loan from the US government. One can intuitively see, therefore, that UNP’s blended cost of funding is very low. DTLs cost nothing, debt costs UNP around 2.5 per cent in US bond markets at present and the remainder is equity.



Another underappreciated aspect of UNP’s business model is the extent to which it stands to benefit from the Trump tax plan beginning 2018. There are three key ways in which UNP stands to materially benefit from the new tax law:

1. From the reduced corporate rate of taxation to 21 per cent (from 35 per cent previously);

2. From the five years of full expensing of new capital investment, followed by the five subsequent years over which this rule will be phased back out again; and
3. From the resulting boost to economic growth in the US which should drive incremental demand for shipments by rail.

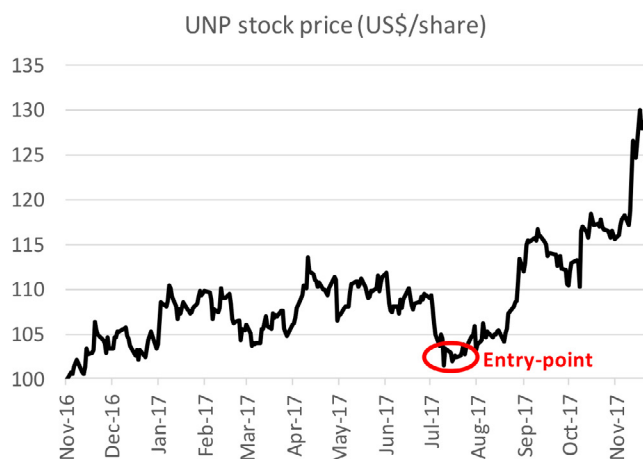
UNP currently provisions taxes at an effective rate of 38 per cent, spends the equivalent of roughly half of its pre-tax earnings in new capital investment each year and is entirely levered to the growth of the real economy. Given this, we struggle to imagine a business that will stand to benefit from Trump’s tax plan relatively more than UNP.

That said, none of this analysis is helpful if the above has already been priced in by the market. Upon applying our Expectations Framework, we believe the market is effectively implying an average revenue growth rate of only 2.5 per cent per annum. This is not only well below the historical average, it is also well below the rates of demand growth we expect to see over the medium term as the US economy strengthens from its “triple dose” of stimulus it is currently experiencing.

When the expectations being implied by the market price of a stock are too conservative, we are interested. In UNP, we believe we have identified a high-quality business positioned in the right market at the right time with market-implied expectations that remain too conservative. Said another way, we believe this stock is materially undervalued.

To round out this case study, our investment in UNP has illustrated a subtle, yet important, distinguishing feature of our global research team: agility. We are a relatively small, flat team of generalists that continually test and evolve hypotheses as a team. Our research process is designed to ensure we only buy businesses when the reward-to-risk ratio is sufficiently high; and our discipline ensures we are patient to wait for the right entry-point.

We have followed UNP in detail for many years but it was only in late July when we believed the time was right to build a position based on the conservative nature of the market-implied expectations of the stock price at the time. A decision to invest that could take months in other research teams took us only days. This agility to act is a source of great advantage for our investors as it allows us to move quickly to pounce on opportunities as and when they present themselves.



* * *

In our review of calendar 2017, we identified the strong and synchronised economic growth being observed in many key regions in the world, including China, the US, the EU and Japan. At the same time, we noted the highly-accommodative monetary policies that continue to persist as we enter 2018. The first-order outlook for 2018, therefore, is a continuation of these wonderful Goldilocks conditions that have served global equity investors so well for nearly two years.

And yet, we have built a healthy dose of conservatism into the Fund's portfolio – the evidence for which can be observed in our 25 per cent cash weighting. The obvious question, of course, is: why so conservative if conditions are so favourable?

It is not the first-order outlook that concerns us. It is the second-order possibilities that may stem from our first-order outlook that give us pause.

Top of our list of risks to be weary of is the Federal Reserve's normalisation of its US\$4.5 trillion balance sheet. Flagged in 2017 to be gently unwound over many years, the Fed may be forced to accelerate its unwinding – pushing longer-term interest rates upwards – as a direct result of the US economy overheating.

It may sound strange to hear of a major economy "overheating" given the preceding decade of sluggish global growth and low levels of inflation. But the Fed believes that the US economy was already operating at its capacity in 2017. And this was before the Trump tax cuts were signed into law.

There are two key reasons why equity investors need to be weary of the Fed's monetary tightening, in our view:

1. As interest rates rise, lower-risk assets, such as bonds, become relatively more attractive than higher-risk assets, such as equities. Under this scenario, capital that has been flowing into equity markets over recent years may reverse course; and
2. The impact of higher borrowing costs for corporates, households and governments can act as an anti-stimulus for the real economy. In particular, consider that US Federal-Debt-to-GDP ratio is a little over 100 per cent – with the majority of this debt maturing in less than five years. This means that, for every one percentage point increase in interest rates, higher government interest repayments will result in around a negative one per cent contribution to GDP growth. This would be a significant drag on economic growth.

The second key risk to be weary of in 2018, in our view, is a slowing of the Chinese economy. All global investors need to focus on the health of the Chinese economy given it has accounted for approximately 40 per cent of total global economic growth over the last decade.

We believe there are two dimensions to a potential Chinese economic slowdown – the first is widely known, while the second is underappreciated:

1. China's growth miracle of the last decade has been largely credit-fuelled and focused on fixed-asset investment. It remains to be seen if there will be genuine write-downs of loans that have funded this investment which could create liquidity problems in the country's US\$15 trillion wealth management sector; and
2. There are increasing indications that the Trump Administration will effect retaliatory trade policies against China in 2018. But unlike many of Trump's proposals, such punitive measures being drafted are reportedly gaining support from both Republicans and Democrats in the Congress.

These are the major risks we are focused on as we enter the new calendar year. We have been surprised by the unusually low variability of global equity market returns in 2017. And while we would hope these conditions continue, this is not a sensible use of time for us. Instead, we are paid to continually evaluate what could happen (not what will happen) and ensure the Fund is positioned appropriately for all possibilities.

We continue to own a portfolio of high-quality global businesses that should remain resilient across a range of global economic conditions. And, of course, what is most important for us is that we believe the market's expectations for these businesses remain too conservative. That is, we believe the stocks we own remain materially undervalued.

* * *

In closing, I would like to take this opportunity to make a special thanks to the entire Montgomery Global team. It has been a year of very hard work by each member of the team. We are proud of our results for the year and look forward to working at least as hard again for our investors in 2018. Finally, we thank each of our investors and readers for their trust and ongoing support. From all of us at Montgomery Global, we wish you a happy and prosperous new year.

