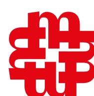


THE MONTGOMERY FUND

INVESTMENT REPORT & FACT SHEET

FUND OVERVIEW

The Montgomery Fund employs a bottom-up, value style to invest and manage the equity portfolio. The Fund has the ability to retain a cash weighting, with a 'soft' 30 per cent limit, while seeking to identify companies that satisfy three main points of criteria. For inclusion in The Montgomery Fund, a business must be of premium quality, display bright prospects for earnings and growth in intrinsic value, and be available to purchase at a reasonable price.

Pursuant to this objective, The Fund aims to deliver superior positive returns where suitable investment opportunities are abundant, and to preserve capital through cash allocations where suitable investment opportunities are scarce.

FUND FACTS

INVESTMENT MANAGER
Montgomery Investment Management Pty Ltd

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

BENCHMARK
The S&P/ASX 300 Accumulation Index

FUND CONSTRUCTION
The Fund's All Cap portfolio will typically comprise 20-40 high-conviction stocks listed on the ASX and/or NZSX. Cash typically ranges from 0%-30%, but up to 50% in extreme situations.

APIR
FHT0030AU

RECOMMENDED INVESTMENT TIMEFRAME
5 years

MINIMUM INITIAL INVESTMENT
$25,000

INCEPTION DATE
17 AUGUST 2012

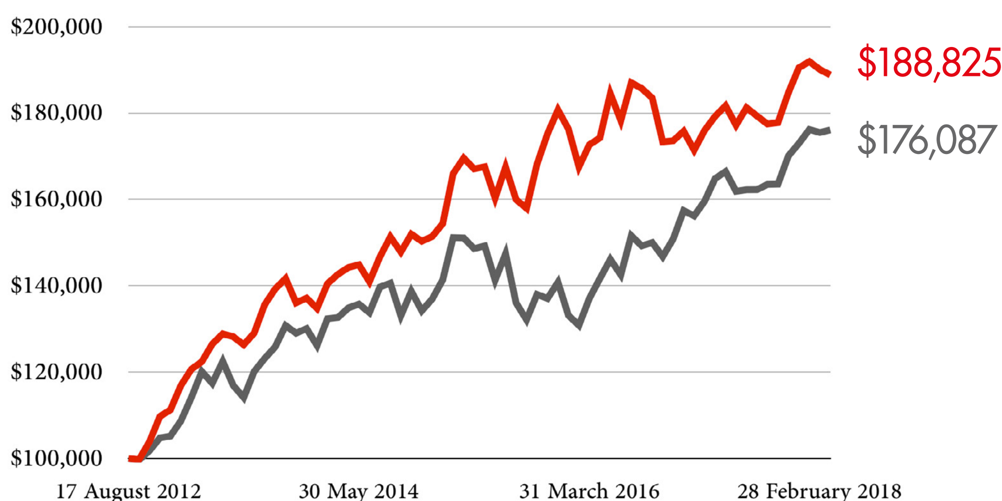
FUND SIZE
$665.2M

MANAGEMENT FEE
1.36% per annum, which includes a management fee of 1.18% per annum. Both figures are GST inclusive and net of RITC.

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

APPLICATION & REDEMPTION PRICES
montinvest.com/tmf

PERFORMANCE GRAPH



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PORTFOLIO PERFORMANCE

(to 28 February 2018, after all fees)

	INCOME	CAPITAL GROWTH	THE MONTGOMERY FUND	S&P/ASX 300 ACCUM. INDEX	OUT/UNDER PERFORMANCE
1 month	0.00%	-0.66%	-0.66%	0.34%	-1.00%
3 months	1.08%	-1.96%	-0.88%	1.80%	-2.68%
6 months	1.16%	5.24%	6.41%	7.72%	-1.31%
12 months	1.87%	5.43%	7.29%	10.34%	-3.05%
3 years (p.a.)	4.89%	-0.49%	4.39%	5.22%	-0.83%
5 years (p.a.)	5.27%	3.80%	9.08%	7.95%	1.13%
Since inception#	35.84%	52.99%	88.82%	76.09%	12.73%
Compound annual return (since inception)#	5.69%	6.48%	12.16%	10.76%	1.40%

17 August 2012

FUND COMMENTARY

After an extended period of very low volatility in equity markets in Australia and overseas, the early part of February 2018 saw a sudden rise in volatility and some sharp declines in market indexes. As we noted in our January report (which was written in early February), the headlines of the day announced the largest ever one-day points drop in US markets. As we wrote at the time, this was unduly alarmist, as it is the percentage drop and not the points drop that matters, but nonetheless, sudden and steep declines were a stark contrast to the steady gains that the market had grown accustomed to.

During this period of weakness, the Montgomery Fund (The Fund) found the opportunity to deploy a small part of its cash balances, but this opportunity proved to be very limited in both scale and time frame. As February concludes, markets appear to have settled at levels broadly similar to those of January, and volatility appears to have subsided.

February also saw the release of half-year profit results for the majority of ASX-listed companies, and a generally satisfactory reporting season no doubt contributed to some restoration of calm. As always, there were some significant price moves in both directions, but in aggregate, reporting season did not ring any alarm bells in terms of earnings. For the companies in The Fund's portfolio, reporting season saw a mix of positive and negative price moves but, overall, we did not see cause for any substantial changes to long-term investment theses, and there were no major portfolio acquisitions or divestments. Among the stronger contributors during reporting season were IDP Education, REA Group and Resmed (which reported in January). Companies with weaker results included Ramsay Health Care and Chorus, both of which we believe have a good long-term outlook.

Continued on the next page..

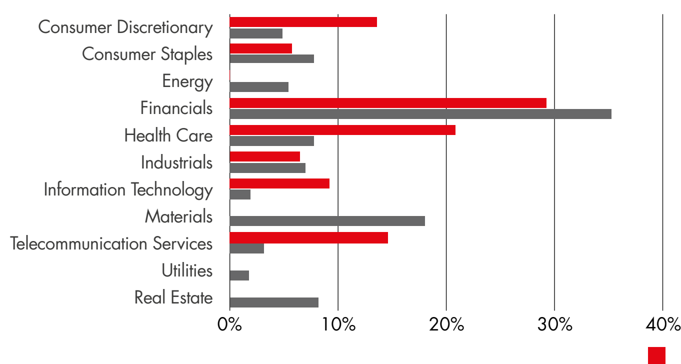
TOP COMPLETED HOLDINGS* (TCH)

(at 28 February 2018, out of 25 holdings)

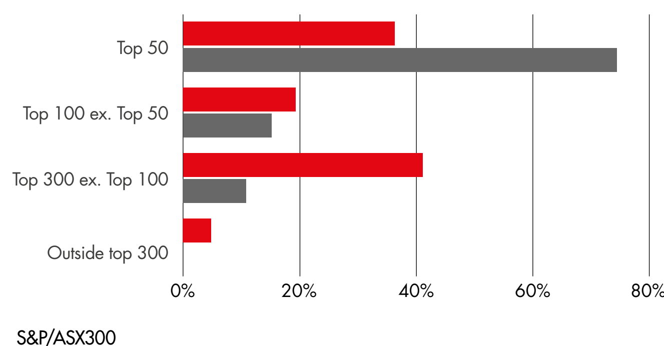
COMPANY NAME	RETURN ON EQUITY (%)	NET DEBT/EQUITY (%)	PRICE/EARNINGS (X)	WEIGHT (%)
Rea Group	21.4	16.7	35.3	6.26
BT Investment Management	19.4	-24.3	16.9	5.07
Ramsay Health Care	26.6	124.1	22.0	5.03
Resmed	22.4	13.1	27.6	4.88
Trade Me Group	13.1	11.5	17.8	4.41
Spark New Zealand	25.0	51.1	15.2	4.39
Seek	17.6	11.8	32.4	4.13
Challenger	12.5	N/A	17.1	4.01
Westpac Banking Corp	13.2	N/A	12.6	3.94
Speedcast International	17.0	121.5	14.4	3.94
TCH AVERAGE	18.8	40.7	21.1	
MARKET AVERAGE	15.6	68.6	18.5	
Total equity weighting				76.5
Total cash weighting				23.5

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

INDUSTRY EXPOSURE



MARKET CAPITALISATION EXPOSURE



TMF S&P/ASX300

PLATFORMS WE ARE ON: Ausmaq AMP PortfolioCare AMP Summit AMP Wealthview AMP North Asgard BT Wrap BT Panorama Colonial First Wrap Clearview Wealthsolutions Investment Exchange (IX) Federation Accounts HUB24 Linear Managed Accounts Macquarie Wrap MLC Wrap Navigator Netwealth IPDS Netwealth Super OneVue Powerwrap UBS

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 Investment Management Pty Ltd, AFSL No: 354564 ('Montgomery') the investment manager of The Montgomery Fund ('TMF'), ARSN 159 364 155. 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 into account your particular objectives, financial circumstances or needs. You should obtain and consider a copy of the Product Disclosure Document ('PDS') relating to the Fund before making a decision to invest. Available here: http://fundhost.com.au/investor/tmf. 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 report. Past performance is not indicative of future performance.

Accordingly, The Fund's positioning remains similar to that of January. With equity valuations generally at elevated levels, The Fund holds a significant cash balance, and is positioned with a view to preserving investor capital in the event that valuations revert to more typical levels. As always, we have no way of predicting when such a reversion might occur, but as the events of February illustrate, investors should not expect a market pullback to announce itself ahead of time and allow time for an orderly repositioning. Market declines can occur very quickly, and capital preservation is something that is best thought about before it is needed.

With reporting season behind us, we take the opportunity this month to provide some additional perspective on the long-term performance of The Fund. We attach a note that outlines the important structural differences between The Fund and its benchmark, the S&P/ASX300 Accumulation Index, and explains how these structural differences influence relative performance over both short and long time frames.

Thoughts on Fund Performance

The Montgomery Fund (The Fund) has as its benchmark the S&P/ASX300 Accumulation Index, which provides a measure of the total return delivered by the overall Australian equity market. The Fund aims to outperform this benchmark over long stretches of time while exposing investors to a lower level of risk and, since its inception in 2012, it has done so. However, the relative performance of The Fund (ie. compared with the benchmark) has been far from consistent. At times it has fared much better than the benchmark, and at times much worse.

The reason for this is that there are some important structural differences between The Fund's portfolio and the benchmark index, and these differences can push The Fund and the benchmark in very different directions over shorter time frames. The important differences are that:

- The Fund is index-unaware in its construction;
- it will not invest in businesses that we consider to be inferior quality; and
- it holds significant cash balances when equity valuations become stretched.

These structural differences exist for good reasons, but they can make the relative performance of The Fund more difficult to assess. We explain the significance of each in turn.

Index-unaware

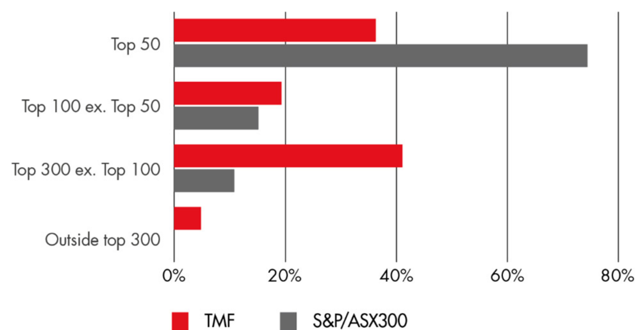
Firstly, the benchmark index is a capitalisation-weighted index, which means that its performance is driven predominantly by the larger companies it comprises. At the time of writing, the largest stock in the index – BHP Billiton – has a market capitalisation of $158 billion, which means that a 1 per cent rise in the BHP share price adds $1.58 billion to the index. At the other end of the scale, the smallest members of the index have market capitalisations below $300m. This means that a 1 per cent change to the BHP share price has a greater impact than a 500 per cent change to the share price of its smaller members.

With limited exceptions (which arise due to liquidity constraints) The Fund ignores market capitalisations and benchmark weights in setting position sizes. This means that a 1 per cent change in the price of a smaller company can have the same impact to the portfolio as a 1 per cent change in the price of a much larger company.

In the long run, we might not expect small companies and large companies to deliver substantially different returns, but over short periods of time, big differences can arise. In simple terms, when several of its largest constituents do well, then the index is also likely to do well.

The index-unaware construction of The Fund means that this effect does not apply. As a result, when larger companies are doing relatively well, The Fund is more likely to trail the index, and when smaller companies are doing relatively well, The Fund is more likely to beat the index. The Fund's current equity weightings shown below, illustrate the greater exposure to mid and small capitalised stocks.

MARKET CAPITALISATION EXPOSURE



The Fund is structured in this index-unaware manner because this provides greater flexibility and diversification than would otherwise be possible. We believe this will contribute to The Fund substantially out-performing over long periods of time.

Quality focus

Secondly, one of the foundations of The Fund's philosophy is investing in high-quality companies, by which we mean companies that have the ability to earn high rates of return on incremental capital investment. Typically, this group includes companies with pricing power, attractive industry structures and barriers to entry.

What typically does not fall into this group is resources companies, which:

- sell into commodity markets where pricing power is very unlikely;
- operate within global industry structures with many competitors; and
- generally operate in industries with low barriers to entry.

Some resources companies are clearly higher-quality than others, and we do not exclude the possibility of investing in them. Similarly, both high and low-quality companies can be found in any market sector. However, resources companies are important because while they form a relatively large part of the benchmark index and have a significant impact on benchmark performance, they tend not to find their way into The Fund's portfolio.

It follows that when resources companies are doing well (as they surely do from time to time), The Fund is more likely to trail the index, and when resources companies do poorly, The Fund is more likely to beat the index.

The Fund focuses on high quality businesses because we believe that over long periods of time, businesses with the ability to create value by reinvesting at high rates of return offer a better investment experience.

Cash Holdings

Thirdly, one of the key objectives of The Fund is to provide investors with a lower level of risk than the overall market, and there are several ways that this objective is pursued. One of these is holding increasing levels of cash when equity valuations become stretched. We have no way of knowing when equity prices may decline, but we do know that paying too much for an asset diminishes the return ultimately earned by the investor. Accordingly, when equity prices appear stretched The Fund tends to park significant levels of cash on the side lines waiting for better opportunities to deploy it. The Fund has a typical cash range of 0-30 per cent, and for a number of years a lack of attractive value opportunities has kept the cash level above 20 per cent.

Another part of The Fund's risk management is in the type of companies that it invests in. Our view (backed up by extensive academic research) is that higher-quality companies tend to shine in more difficult markets. When everything is going well, investors are more willing to seek out risk, and businesses perceived to be safer can get left behind. When investors become worried, a 'flight to quality' is more likely.

One way to quantify this difference is using the estimated Beta of The Fund's portfolio, which measures the expected relationship between The Fund and the index. A portfolio with a Beta of 1 would be expected to gain 1 per cent for every 1 per cent gain in the market (leaving aside any impacts from good or bad stock selection).

Given that The Fund holds cash, we should expect it to have a Beta of less than 1, but the nature of the companies held in The Fund tends to bring the portfolio Beta down even further. At the time of writing, The Fund has an estimated Beta of around 0.6, which means that – all else being equal – we should expect The Fund to rise by 6 per cent in a market that rises by 10 per cent and fall by 6 per cent in a market that falls by 10 per cent. Because of this, the behaviour of the overall market has important consequences for relative performance.

Pulling it all Together

Understanding these fundamental differences allows us to clearly describe the conditions in which The Fund will outperform or underperform. In simple terms, The Fund is likely to beat the index when smaller companies are doing well; when resources companies are under pressure; and when market conditions are challenging.

We can illustrate these dynamics by looking at the historical performance of The Fund in the context of how these factors have behaved. The table below shows the behaviour of the different factors[1] during the calendar years since inception of The Fund, and the corresponding Fund performance relative to its benchmark.

As shown in the table, in the years where these factors have lined up in its favour, The Fund has outperformed. In years where these factors have been against it, The Fund has underperformed. Notably, The Fund had its best relative performance in 2015 when there were no crosses in any of the boxes. By the same token, The Fund had its worst relative performance in 2016 when there were no ticks in any of the boxes.

These factors can have a decisive effect over shorter time frames. However, in the long run, we would expect to see a mix of conditions such that the ticks and the crosses broadly cancel each other out, and relative performance is not unduly affected. Instead, we expect that the long-term relative performance of The Fund will be driven by the success of The Fund's philosophy and stock selection methodology. While stock selection will undoubtedly include a mix of success and failure, we believe that if we apply a logical investment process consistently and diligently, significant benefits should accrue over time.

Pleasingly, in looking at the long-term performance record of The Fund we see good evidence of this happening. Over its life, The Fund has delivered a slightly better return than the market with significantly lower risk. The risk has been low for the reasons outlined previously – The Fund tends to hold cash, and it tends to be biased towards higher quality and less volatile stocks. Returning to the table above, we see that in the years since inception, we have not yet experienced challenging market conditions (which we defined as a negative return for S&P/ASX300 Accumulation Index in a calendar year). Accordingly, the crosses have so far been stacked against The Fund on this front, and relative performance has been held back accordingly.

If we look only at the invested component of the portfolio (ie. setting aside the cash component) we find that the performance of the invested component has comfortably beaten the index. This gives us a measure of confidence that our stock selection efforts – on average – are successful.

While it hasn't happened yet, at some point down the track we anticipate that we are likely to see a serious market pullback, and The Fund's cash holdings will then provide an offsetting relative performance benefit. Following such a pullback we anticipate that we will have the opportunity to deploy that cash and more fully exploit our stock selection capability. This should in turn contribute to good investment results in subsequent periods.

Calendar Year	Market challenging?	Small caps strong?	Resources under pressure?	Combined	Index return	Fund return	Relative performance
2013	×	×	√	×	19.7%	17.3%	-2.3%
2014	-	-	√	√	5.3%	10.4%	5.1%
2015	-	-	√√	√√	2.8%	19.4%	16.6%
2016	×	-	××	×××	11.8%	-2.7%	-14.5%
2017	×	√	×	×	11.9%	9.2%	-2.8%

[1] 'Market challenging' means a total return below zero for the S&P/ASX300 Accumulation Index. An 'X' denotes a positive return of greater than 10 per cent. 'Small caps strong' means an S&P/ASX Small Ordinaries Index return more than 10 per cent above the S&P/ASX300 Index return. An 'X' denotes a return more than 10 per cent below the S&P/ASX300 Index. 'Resources under pressure' means an S&P/ASX200 Materials Sector Index return more than 10 per cent below the S&P/ASX200 Index. An 'X' denotes a return more than 10 per cent above the S&P/ASX200 and 'XX' denotes a return for the S&P/ASX200 Materials Sector Index more than 20 per cent above the S&P/ASX200 Index. Table excludes partial years in 2012 in 2018.

Summary

To summarise, The Fund has been designed to offer long-term investors a good chance of beating the index by a large margin with controlled risk. To achieve this, The Fund needs to be very different to the benchmark it is trying to beat, and this will inevitably result in years of outstanding relative performance, and years of very weak relative performance.

These short-term swings mean that The Fund requires a long-term perspective and is not necessarily an easy one for investors (or their advisors) to hold. However, we hope that a good understanding of why this is the case makes it easier for investors to view these swings in the proper context.