

MONTGOMERY ALPHA PLUS FUND

Annual Letter to Investors

July 2018



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To our Investors:

July 2018

The Montgomery Alpha Plus Fund (The Fund) delivered a flat result for the 2018 financial year. After starting the year on a weak note, The Fund recovered the early losses to be approximately square by 30 June 2018. While the more recent recovery is pleasing, our expectation for The Fund is to deliver very significant positive returns on average, and with a negative year in FY2017 and a flat year in FY2018, The Fund has not yet lived up to this expectation.

During this past year we have undertaken extensive analysis of the performance of The Fund, and to cut straight to the chase, we are convinced of two things:

- Firstly, The Fund's strategy is sound, and has the ability to deliver attractive risk-adjusted returns over long stretches of time; but also,

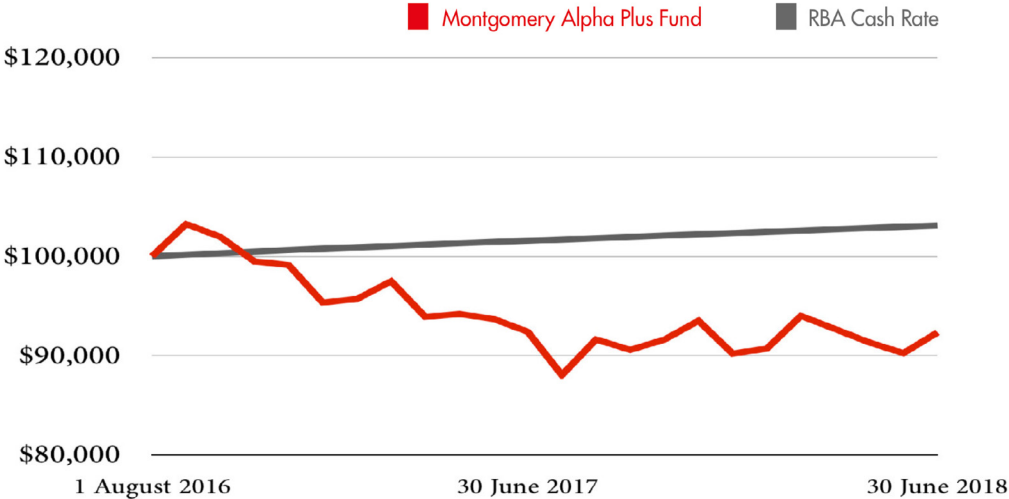
- The Fund's concentrated nature promotes inconsistency of returns and demands investor patience, with the potential for some very good years, but also the potential for some unduly weak years.

Fluctuations in performance are a part of any active investment strategy. However, we believe that scope exists to significantly improve consistency of returns for The Fund without sacrificing potential long-run performance. In this letter we will set out our analysis and reasoning for this, and the proposed changes to achieve improved consistency.

Fund Strategy

To begin with, it is helpful to recap on the way The Fund invests. There are two key dimensions to The Fund's stock selection process: business quality and forecast investment return.

Figure 1: The Montgomery Alpha Plus Fund Performance Since Inception



Source: Fundhost

Business Quality

We consider business quality to be the ability of a business to invest incremental capital at high rates of return and thereby create value for shareholders. Businesses that have this ability are generally those that enjoy some form of enduring competitive advantage due to things like: favourable industry structure, scale advantages, high switching costs and pricing power.

We gauge business quality for all of the companies in The Fund's investment universe by scoring each company across 11 different quality dimensions, including the factors listed above and other similar factors. This scoring is undertaken by the research analysts in our investment team and gives us a numerical quality score for each company in The Fund's universe.

We expect that over long time frames this numerical quality score will show a positive correlation with investment performance, as higher-quality companies deliver better returns than lower-quality companies. In the two years for which The Fund has been running, however, the opposite has been true. In analysing the numbers we find a small negative correlation of approximately -2.2 per cent in the Australian equity market.

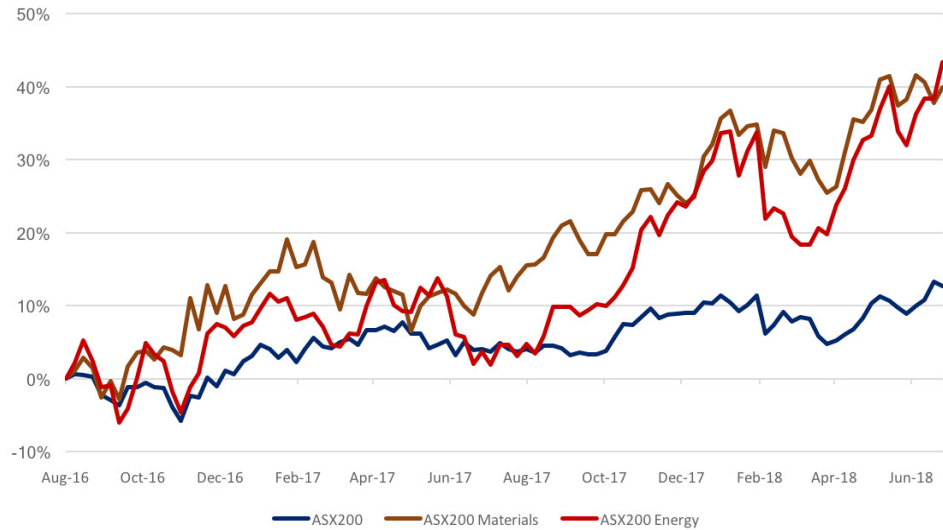
This small negative correlation might not seem like much, but in equity investing, a small correlation is what separates good results from bad results. For reference, we consider a correlation of +5 per cent to be good, and a correlation of +10 per cent to be very good. At this level, The Fund would readily achieve its performance objectives. A result of -2.2 per cent is not terrible, but it does mean that quality has presented a meaningful performance headwind over the last two years.

Correlation coefficients provide a simple, convenient yardstick, but it is helpful to dig a bit deeper to understand the underlying market dynamics. When we score companies in terms of their quality, we generally score resources companies towards the lower half of the quality scale. In large part, this is because commodity producers have no pricing power, and tend to be hostage to forces of supply and demand, rather than being masters of their own destiny. This has particular significance in Australia where resources companies make up a large part of the equity market and being structurally biased against them can become a meaningful issue.

In particular, it becomes an issue when a strong run for global commodity prices drives up the share prices for resources companies, and this is exactly what we have seen in recent years.

The chart on the following page shows the performance of the S&P/ASX 200 Index, together with the performance of the S&P/ASX 200 Energy Sector Index and the S&P/ASX 200 Materials Index in the period since the inception of The Fund. As you can see, sectors of the market that we would consider to be lower quality have enjoyed a period of strong performance.

Relative Performance



Source: Bloomberg

We believe that over long stretches of time, higher quality businesses are likely to deliver better investment returns for investors, but clearly, this additional return comes with a caveat. In the Australian market, investors who focus on high quality businesses (where resources companies are not considered high quality) will sometimes face strong headwinds while commodity prices enjoy a cyclical upswing. On the other hand, they will sometimes enjoy strong tailwinds when commodity prices experience a cyclical downturn.

The Fund can (and does) take long positions in resources companies. However, the quality dimension of The Fund's investment process has resulted in The Fund being net short materials stocks and net short energy stocks at all times since inception, with the combined net short position at times exceeding 30 per cent of fund net asset value.

While the idea of having a bias to high-quality companies has strong intuitive appeal and academic support, there will be times when it is unhelpful. In the Australian market, in the period since inception of The Fund, a long high-quality/short low-quality bias has certainly been unhelpful.

Forecast Return

The other key driver of The Fund's stock selection process is a quantitative forecast of investment returns. We construct a forecast return for every stock in The Fund's universe using a machine learning model that has been trained to assess the investment merits of listed companies using analysis of financial statements, broker consensus forecasts and share market trading data.

Using large amounts of historical data, the model is able to learn which financial ratios and other pieces of information are most helpful in evaluating companies, and as new data becomes available the model is progressively updated.

This approach allows us to quickly and consistently assess every stock in The Fund's universe and to forecast which are more likely to do well in the foreseeable future, and which are more likely to do poorly. The machine-driven nature of this methodology makes it highly repeatable, and allows us to evaluate the performance that would have been achieved using the same approach in previous periods (so called "back testing"). This testing provides an indication of the investment returns the process should be capable of delivering.

When we examine the performance of this aspect of The Fund's investment process, we find that in the period since inception of The Fund, the results have fallen short of what the back testing indicates. While it does not look to have detracted greatly from performance, quantitative return forecasting has not delivered the strong positive results that we expect it to deliver on average, and has instead been a slight negative.

Two alternative explanations for this might be considered: One is that our methodology is flawed such that future results will not live up to the back test results, even over long stretches of time.

Another possibility is that our methodology is sound, but results will inevitably fluctuate from time to time, with some excellent periods, and some poor periods averaging out to produce good results long term.

Based on previous analysis, we certainly expect fluctuations in performance, and it is entirely plausible that the period since inception of The Fund reflects these normal fluctuations. However, with actual performance falling short of expectation, some additional analysis is warranted.

An important question that arises when actual performance falls short of back test results is that of overfitting. By allowing a model to become overly complex, it is possible to make it work extremely well for historical data (so called “in-sample” data), but much less well for future forecasts (so called “out-of-sample” data). This happens where the model is moulded to unique features that arise in the historical data, but which may never be repeated in future. Quantitative model builders need to be alert to this risk and actively guard against it.

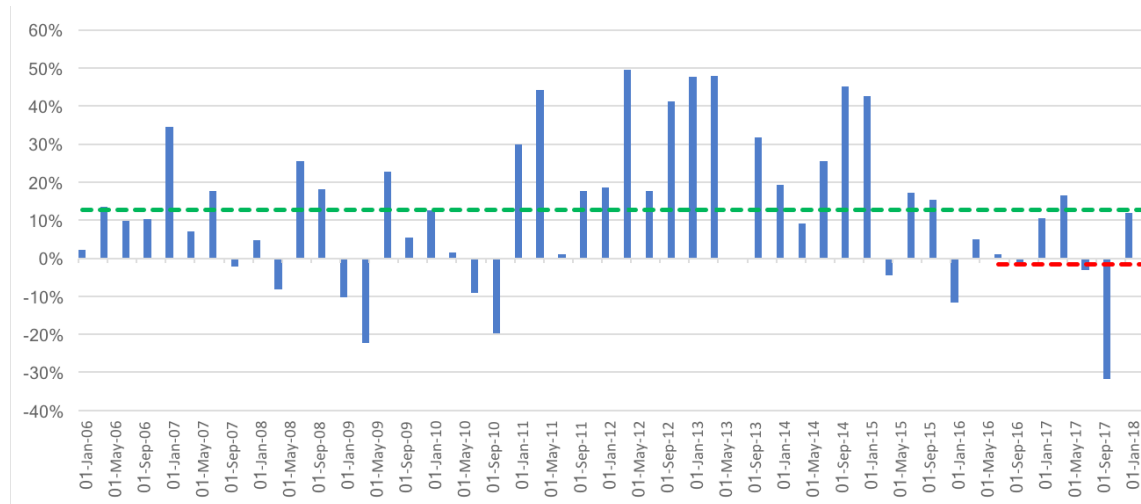
There is a straightforward way to assess whether we are experiencing an overfitting problem. We can do this by including the most recent historical data as part of our “in-sample” data set and applying our standard model building process to this extended data. If we are guilty of overfitting, a model built in this way should work well on the most recent data.

Alternatively, if a model built in this way does not work well on the most recent data, then the performance shortfall is more likely part of the natural ebb and flow of good/bad luck that arises for any investment approach.

The results of this analysis are reasonably clear: a model constructed with the last two years included as part of the “in-sample” data works extremely well over time frames of a decade or so, but during the most recent two-year period it shows a (small) negative return.

Quarterly Forecast Correlation

The following chart shows the results of this, with the blue bars representing the correlation coefficient achieved by the model in each quarter.



Source: MIM analysis

You can see that, on average, the correlation coefficient is above 10 per cent (the green line), which is extremely good. We do not necessarily expect to achieve performance at this level going forward, as some decline is to be expected out-of-sample. However, we do expect to be in the 5-10 per cent range needed for good to very good performance.

You can also see that the last two years have been a poor stretch for the model (the red line), with the average correlation coefficient a small negative (-1.6 per cent). Recall again that this entire data set is in-sample, and this two year period cannot be explained by out-of-sample performance decline or overfitting.

These results provide a strong indication that, in the period since inception of The Fund, the soft results from our return forecast models owe more to the natural ebb and flow of luck than to anything else.

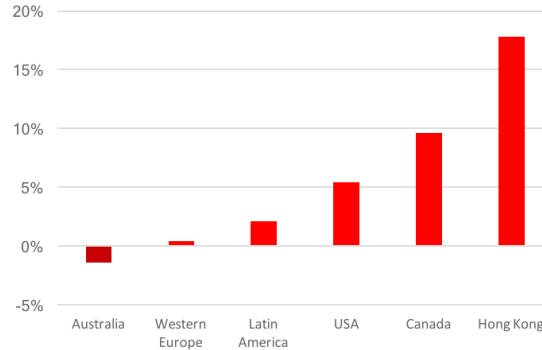
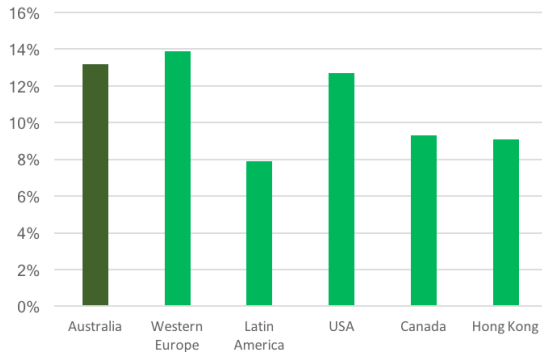
Global Perspective

We can learn more by repeating this type of analysis in other equity markets beyond Australia. While The Fund has historically limited its investment universe to the Australian and New Zealand markets, our model building approach can be (and indeed has been) applied to all the major global equity markets. Different markets have different characteristics, and the individual forecast models contain different elements, but the methodology used to build them applies universally.

Forecast Correlation – Full Time Period

Forecast Correlation – Last 2 years

We summarise the results in the following charts. The chart on the left sets out the average correlation for each model in its relevant market for the full time period (equivalent to the green line above), and the chart on the right sets out the correlation coefficients for the most recent two years (equivalent to the red line).



Source: MIM analysis

The results reveal some useful insights, including:

- Across all markets, averaged across the full decade or so of data, the results appear pleasing. Correlation coefficients all fall in a range of around 8-14 per cent, sufficient to generate good to very good investment results in all cases.
- For the most recent two years however, the results are much more varied. The Australian market is the worst (and the only one with a negative result), while Hong Kong delivered an exceptional 17+ per cent. The other markets are arranged between these extremes.

This variability over the recent period is consistent with what we would expect, and consistent with our earlier conclusions. Over short periods any investment strategy will deliver relatively variable performance, but over longer periods the variations will tend to even out.

However, the fact that Australia was the worst performing of all the markets examined is a little infuriating.

Quality Double Count

From the preceding analysis we take a good measure of comfort that The Fund's strategy is sound and that the soft performance since inception is likely to be driven by a shortfall of luck. However, there is one further piece of analysis to conclude our exploration of performance, and to fully highlight the opportunity to improve performance consistency going forward.

Earlier we identified that a large contributor to the Fund's performance during this period was a negative correlation in Australia between business quality – as measured using our subjective framework – and investment performance.

In simple terms, we experienced during this time a so called “junk rally” whereby lower-quality cyclical companies enjoyed cyclical tailwinds and outperformed higher-quality businesses.

We discussed this in the context of our subjective quality assessments. However, it is also important to note that our machine learning models also include quantitative aspects of business quality in their formulation. Quality features in the forecast models include things like: historical return on equity, volatility of earnings and share prices, capital intensity, and accounting accruals. These sorts of quantitative metrics find their way into the forecast models via the machine learning process because quality – over long stretches of time – works. Higher quality businesses tend to deliver better long run results, and this gets reflected in the factors adopted by the machine learning models.

The quality loading that exists in the forecast models is apparent when we look at the correlation between our subjective quality scores and the forecasts produced by the quantitative models. In Australia, over the past two years, this correlation has been significant, at approximately 26 per cent.

In other words, quality appears in both elements of The Fund’s investment strategy and, while it works in the long run, quality has not been rewarded in Australia during the last two years.

Given the global nature of the cyclical drivers and the broad nature of the so-called “junk rally”, we expect that quality has been a headwind not only in Australia, but in global markets generally.

Next Steps

Based on the analysis set out above, we feel confident that The Fund's strategy has the ability to deliver good results over long time frames, but what is also clear is that the results will vary. Patient investors should be well-rewarded, but a good level of patience is required when headwinds prevail.

However, the analysis also highlights changes that can be made to The Fund's strategy that we think can achieve similar long-term returns while significantly reducing short term fluctuations and the need for patience. This can be achieved by:

- Diversifying The Fund's investment portfolio across global markets, rather than focusing on Australia and New Zealand; and

- Reducing The Fund's concentration on business quality by removing the subjective business quality assessment and relying on the quality elements already present in the quantitative forecast models.

These proposed changes would result in The Fund being invested in a much larger portfolio drawn from a much wider set of global securities, with stock selection driven by a broader set of quantitative models, each individually designed for the relevant market. This increased diversification across stock numbers, geographies, and forecast models should significantly improve consistency of results, by avoiding situations where (for example) The Fund is focused on the worst (or indeed the best) market for a given period.

The reduced weighting on business quality should also improve consistency by avoiding situations where a global cyclical rally makes conditions challenging for a fund that is very “long” quality.

The underlying nature of The Fund will remain very much as it is. It will continue to invest similar amounts in a long and a short portfolio of equities to maintain a broadly “market neutral” stance. Its returns will continue to be driven by stock selection rather than overall market movements, and it will continue to target equity-like returns with lower than equity risk levels.

We feel that this opportunity to reduce variability without needing to sacrifice long-run expected returns is about as close to a free lunch as we are likely to find in investment management, and we propose to make the appropriate changes to achieve this as soon as practicable.

Formal documentation will be sent to investors shortly. There is no need for you to take any action to complete the proposed changes, but under The Fund’s constitution, a 30-day notice period must be observed. We anticipate being able to reposition The Fund as a globally diversified vehicle within the next few months.

We are excited about the proposed changes and the much wider opportunity set that they will open for The Fund. Consistent with this, Montgomery staff intend to add to their personal investment in The Fund.

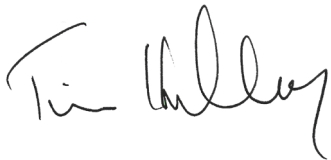
We thank you for your support of The Fund in FY2018 and look forward to working to deliver attractive investment returns from The Fund in the years to come.

Sincerely,

Tim Kelley

Portfolio Manager

The Montgomery Alpha Plus Fund

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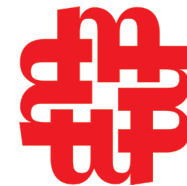
Roger Montgomery

Chairman and Chief Investment Officer

Montgomery Investment Management Pty Ltd

A handwritten signature in black ink that reads "Roger Montgomery". The signature is written in a cursive style with a large, prominent initial "R".

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