MONTAKA
GLOBAL ACCESS FUND

MONTAKA

QUARTERLY LETTER

JUNE 2019

UNIT PRICE [1] $1.1231

FUND COMMENTARY

In the month of June, the Montaka Global Access Fund (the Fund) increased by 1.60 per cent, net of fees. This brings the June quarter to a close with a return of 2.17 per cent, net of fees. Calendar year-to-date, the Fund has returned 10.10 per cent, net of fees. And over the year ending June 30, the Fund returned 2.79 per cent, net of fees.

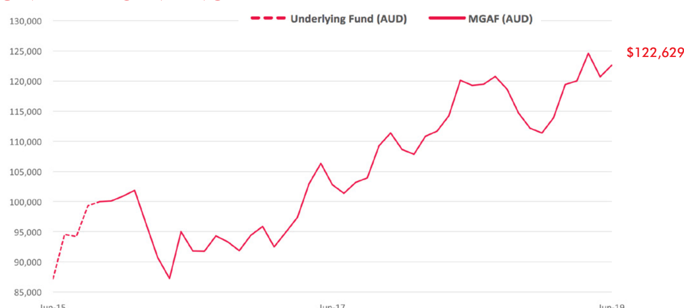
Since inception, the Fund has returned 22.63 per cent, net of fees. This return has been delivered with an average net market exposure of approximately 47 per cent. By comparison, the MSCI World Total Return Index in Australian dollar terms, which naturally carries with it 100 percent net market exposure at all times, returned 39.66 per cent over the same period.

As readers know, the Fund is a "variable net" strategy meaning that the Montaka investment team can move the portfolio's net market exposure (long exposure, minus short exposure) and gross exposure (long exposure, plus short exposure) around to reflect the global environment, opportunity set and market conditions. We set the Fund's aggregate portfolio exposures to reflect the range and probabilities of possible globally significant outcomes that are not being fully reflected by stock prices.

Over the last 12 months, there were a number of occasions during which top-down augmentation of the Fund's portfolio exposures were warranted. These included:

- In early September, 2018: we reduced our net and gross exposures (thankfully) prior to the onset of the Q4 global equity market downturn.

FUND PERFORMANCE



PERFORMANCE ATTRIBUTION[1]* (%)

	June 2019
Long portfolio contribution	4.20
Short portfolio contribution	(1.48)
Change in AUD/USD	(1.12)
Net return	1.60
Since inception[2]	22.63

EXPOSURES (as at 30 June 2019)

	% of NAV
Long exposure	94.2
Less: short exposure	(46.0)
Net market exposure	48.2

POSITION METRICS (as at 30 June 2019)

	Long Portfolio	Short Portfolio
Number of positions	20	30
Largest position size	7.4	2.2
Smallest position size	2.6	0.7
Average position size	4.7	1.5

Note: sizes shown as % of NAV

TOP 10 LONG POSITIONS (as at 30 June 2019)

		% of NAV			% of NAV
1	Vivendi	7.4	6	Alphabet	5.5
2	Prudential	6.6	7	St James's Place	5.2
3	Insperity	5.9	8	Facebook	5.2
4	REA Group	5.6	9	Alibaba	5.2
5	Microsoft	5.5	10	Airbus	4.8
Total top 10 long positions					56.9

FUND SIZE (NAV) ($M) (as at 30 June 2019)

Montaka Global Fund	185.3
of which: Montaka Global Access Fund	74.9

PERFORMANCE (%)	1M	3M	12M	2 Yr pa	3 Yr pa	COMPOUNDED ANNUAL RETURN SINCE INCEPTION	SINCE INCEPTION
Fund (AUD)[2]	**1.6**	**2.2**	**2.8**	**9.2**	**10.1**	**5.7**	**22.6**
Underlying Fund (AUD)[4]	1.6	2.2	2.8	9.2	10.1	8.9	40.6
Average Net Market Exposure	48	43	46	45	47	47	47
Global Market (AUD)[2,5]	5.2	5.3	12.0	13.6	14.0	9.6	39.7
Average Net Market Exposure[3]	100	100	100	100	100	100	100

2019 distribution will be advised in August 2019. The numbers in this report are on cum distribution basis for 2019

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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At the time, we believed stock prices generally were not fully reflecting the impact of a tightening Fed combined with the onset of the US/China trade dispute.

- In mid-December, 2018: we then significantly increased our net and gross exposures – substantially driven by buying in our long portfolio – to take advantage of the significant overreaction that was being reflected in stock prices at the time. We believed stock prices generally were not reflecting the impact of the Fed's abandonment of its tightening bias.

At first, these sharp changes in portfolio exposures over a relatively short amount of time may appear somewhat erratic. But when viewed through the lens of what the future could have (and likely would have) held at these different points in time, the portfolio augmentations make more sense.

In managing risk, we need to consider the range of possible scenarios that may conceivably lie ahead. And when evaluating the past, while only one scenario will ever have materialised, it is important to consider the range of "alternative histories" that could have played out. This concept of risk management is articulated in a creative way by Annie Duke in her recent book, Thinking in Bets. Here is how she illustrates the concept of risk:

"Think about time as a tree. The tree has a trunk, branches at the top, and the place where the trunk meets the branches. The trunk is the past. A tree has one, growing trunk, just as we have only one, accumulating past. The branches are the potential futures. Thicker branches are the equivalent of more probable futures, thinner branches are less probable ones. The place where the top of the trunk meets the branches is the present. There are many futures, many branches of the tree, but only one past, one trunk… When we look into the past and see only the thing that happened, it seems to have been inevitable… That's hindsight bias, an enemy of probabilistic thinking."

To continue Duke's metaphor, the shape of the tree's branches changed frequently and significantly over the last 12 months for global equity investors. And the June quarter was no exception.

On May 3rd, it was reported that Beijing sent a diplomatic cable to Washington with wide-sweeping edits to the 150 page draft trade agreement that the two nations had been working on for months. Furious with this new development, President Trump then indicated that by the end of the following week, tariffs on $200 billion of Chinese imports would be increased from 10 per cent to 25 per cent.

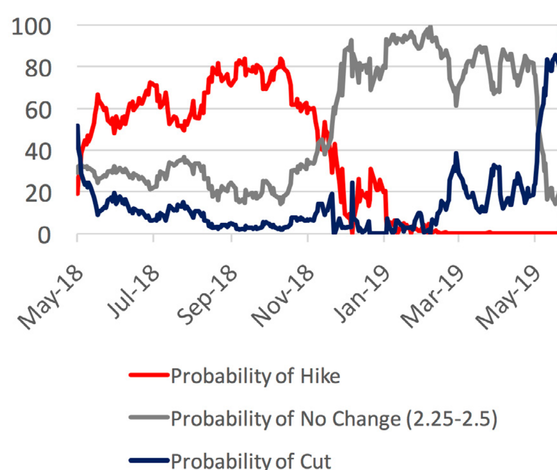
Within days, it was our view that the probability of escalation had increased materially; and that, should escalation materialise, this was not being reflected in stock prices. As such, we significantly reduced the Fund's net and gross exposures.

This turned out to be sensible because the following week on May 15th, President Trump signed an Executive Order to allow the Commerce Secretary to block US companies from transacting with certain foreign telecommunications providers.

It is no secret that the Trump Administration – and the US Intelligence Community – are concerned that Chinese telecommunications giant, Huawei, is interested in both technology transfer and possible intelligence collection in foreign telecommunications networks. Meanwhile, the company's CFO (who is also the daughter of Huawei's founder) remains in detention in Canada at the request of the United States Department of Justice who believes that she – and the company – have engaged in financial fraud.

In global fixed income markets, bond yields started falling rapidly, as did market-implied inflation expectations. But then something strange happened at the end of May: the market's expectation for global monetary conditions took a sharp turn from "neutral" to "easing" in a matter of days and global equities started rallying sharply. We did not see this coming and were positioned too conservatively, with the benefit of hindsight. Even looking backwards in time, we view the strength in equities in the first two weeks of June as a low probability outcome. A higher probability scenario was for more downside and that is what we had our eye on protecting against – albeit incorrectly, this time.

Market-implied probability of Fed interest rate change at July 31, 2019 meeting



Source: Bloomberg

Later in June, we heard from the ECB, the Fed and the BOJ. The range of possible outcomes for equities leading into these disclosures by two of the world's major central banks remained skewed to the downside, in our view. The market was already pricing in a complete change in monetary bias, so any disappointment would likely have resulted in an equity market sell-off.

Instead, all three major central banks delivered what the market was hoping for – raising genuine questions if the market essentially forced the hands of these policymakers. That is a scary thought, in and of itself. But it certainly appears like the change in tone, at least from the Fed, was pre-emptive in nature. That is, despite telling the market for years that monetary policy will be "data dependant" the Fed had now delivered to the market what it wanted, absent the data to warrant such a move.

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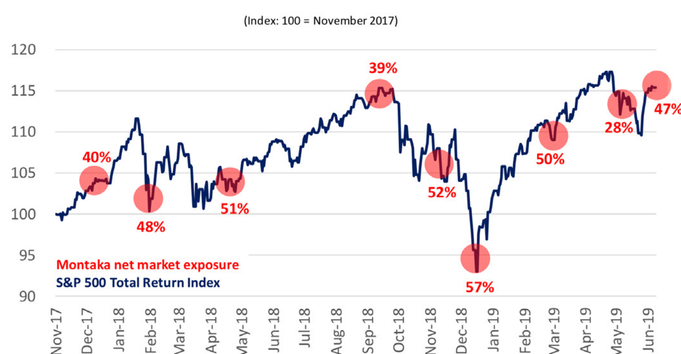
Our evidence for this is the Fed's own forecast for 2020 real GDP growth in the US which was actually upgraded from three months prior, despite the Fed's interest rate trajectory forecast being downgraded to an easing bias.

This change in the global monetary bias is significant for global equity investors. It says to us that the global cost of capital will likely remain lower for longer. And equities today – or at least some equities today – still do not reflect a structurally lower cost of capital for the longer-term. As an aside, we have noticed a large number of foreign takeovers by Japanese acquirers in recent years at seemingly very high valuation levels. But for a nation whose government has been able to issue 10-year bonds at or below zero for the last four years, perhaps the Japanese know something about the true cost of equity capital that western investors have not yet fully understood. We increased the Fund's portfolio exposures as a direct result of this new information from the ECB, Fed and BOJ.

Montaka Net Exposure vs S&P 500



Source: Bloomberg; MGI

The quarter finished with Presidents Trump and Xi meeting to discuss the future of their trade dispute on the sidelines of the G20 summit in Japan. The two presidents agreed to resume trade talks – which is clearly positive in the sense that an alternative outcome of further escalation would have been highly negative for global markets. We do note, however, there was no progress made on any issues of substance at the G20 meeting.

The political incentives for both Presidents Trump and Xi continue to favour a compromise. From Trump's perspective, he needs a deal before the November 2020 elections to boost his chance of re-election. From Xi's perspective, while he does not have term limits (anymore), the Chinese economy is slowing and remains significantly more fragile than that of the United States'. That said, predicting the behaviour of these two men – which oddly has become a key determinant of stock prices all around the world – is impossible.

Instead, we derive peace of mind from knowing that the businesses we own in the Fund's portfolio are privileged business models, in structurally growing industries and which remain materially undervalued today.

By owning businesses which are positively exposed to structural industry tailwinds, we can look-through much of the short-term market volatility and have peace of mind that the businesses we own will likely be significantly more valuable in the future than they are today. From digital music streaming, to digital advertising spend, to cloud-based enterprise infrastructure and enterprise applications, to US demographic changes, to growth in Asian middle-class wealth levels. These are just some of the multi-year and multi-decade trends to which Montaka's portfolio businesses are positively exposed.

Chris Demasi explores one of these structural growth drivers in more detail below as he summarises our thesis in Airbus (Euronext: AIR). As wealth levels of the Asian middle-class increase, so too does the demand for air travel. And this in turn is providing a long-term structural tailwind to Airbus. And most importantly, we believe the full extent of this growth is currently being underappreciated by the market.

CASE STUDY: AIRBUS

The Montaka funds have successfully held long positions in Airbus (AIR FP) stock for several years. Looking forward, we think Airbus remains a wonderful investment opportunity because it is a high-quality business with a long runway for profitable growth that is not fully appreciated by the market.

United Europe success story

In the years following the end of the second World War, European aircraft manufacturers found competing with larger American peers Boeing, McDonnell Douglas and Lockheed increasingly difficult. While the Europeans might have been just as innovative as the Americans, acting independently they were too small to bear development risks and achieve production efficiencies.

Though not without hiccups along the way European aviation companies and their governments seem to have heeded the advice of Britain's wartime Prime Minister, Sir Winston Churchill, to great effect: "If Europe were once united in the sharing of its common inheritance there would be no limit to the happiness, prosperity and glory…We must build a kind of United States of Europe"

Negotiations over a collaborative European approach began at the 1965 Paris Air Show and by 1967 France, West Germany and the UK were working together on a new "Airbus". This paved the way for Airbus to be formally established in 1970 with German, French, British and Spanish partners. The consortium's first commercial plane went into service in 1974.

Today Airbus is the second largest aerospace and defence company in the world with €70 billion in annual revenue and an order book valued at almost half a trillion Euros across three operating segments. But the commercial passenger aircraft business is still the crown jewel in the Airbus empire, contributing 75 per cent of total company revenues and 90 per cent of profits.

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Airbus is the world leader in producing passenger aircraft for commercial airlines, including the narrow-body A320, the wide-body A350, and the world's largest passenger airliner, the A380. In addition, Airbus Helicopters is a global leader in civil and military rotorcraft, and Airbus Defence and Space is a leading supplier to militaries and the space industry.

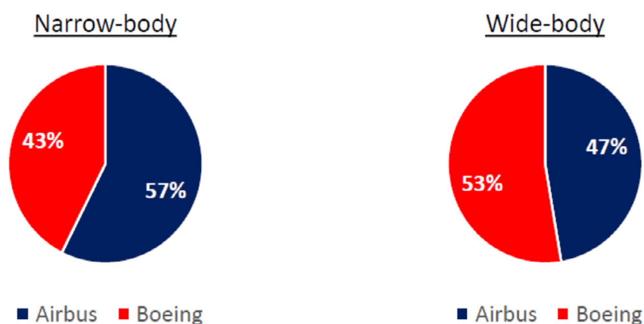
Reflecting its pan European heritage and global expansion, Airbus is headquartered in the Netherlands; with its main office in France; shares traded in Paris, Frankfurt and Madrid; and assembly lines and suppliers located around the world.

Leading a two-horse race

Airbus is undoubtedly a high-quality business, which stems from its market-leading position in the attractive industry for passenger aircraft and is demonstrated by return on equity above 30 per cent.

Airbus leads US-based Boeing in a global duopoly for passenger jets. The A320 family accounts for almost 60 per cent of all narrow-body plane orders worldwide, leading Boeing's 737 platform. In the market for wide-body planes, Airbus' A330 and A350 together account for almost half of the global industry order book. Airbus's backlog of more than 7,000 orders represents nine years' worth of production and secures its leadership for the foreseeable future.

Market share of backlog (number of aircraft)



Source: Company filings

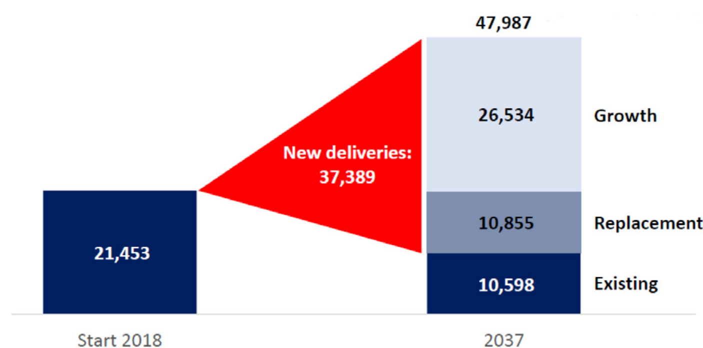
This privileged market structure is virtually impervious to disruption because the barriers to entry are extremely high for potential new entrants. Initial capital outlays for aircraft development can easily reach tens of billions of dollars, run over-budget, and have pay-back periods longer than a decade. For example, Airbus expected development costs for its A380 to be $10 billion in 2000 but they ultimately expanded to $25 billion and may not be fully recouped. The technological expertise required to develop aircraft and the commercial relationships needed to sell them to airline and leasing customers years in advance are also built over decades. Deep pockets, know-how, know-who and time are strong advantages for Airbus.

Tailwinds for decades

Airbus will benefit from structural growth in air travel for decades. Airbus estimates that more than two billion people will join the global middle class over the next 20 years. Higher disposable incomes for this cohort are expected to drive global air passenger traffic to more than double over this period.

At the same time airlines around the world are operating their fleets at the highest load factors (or fewest spare seats) on record. In order to meet such robust growth in air travel airlines will need to expand their fleets significantly. Airbus estimates that the global fleet of passenger planes will more than double over the next two decades and airlines will need to purchase over 37,000 new jets. Airbus A320 and A350 families feature prominently in airline expansion plans.

Global passenger aircraft fleet (number of aircraft)



Source: Airbus

Even with Airbus close to producing the A320 family at a rate of 60 per month, and stepping up in coming years, it still cannot deliver the single-aisle jets quickly enough. A320 delivery slots are full looking out four years.

Insatiable demand for the A320 has allowed Airbus to command premium pricing at the same time as customers are choosing larger, longer-range, next-generation engine variants that are all more profitable for Airbus. At the Paris Air Show this month Airbus launched the A321XLR with 15 per cent higher range, 30 per cent lower fuel burn, an extra fuel tank, more seating and immediately gained hundreds of orders.

Meanwhile production of the A350 will ramp well above 100 this year. Profit margins will turn positive and inflect upwards as the program continues down the industrial learning curve, unit costs fall, and pricing improves.

Stock taking off

Ultimately, we see a potential path for Airbus to grow volumes over the next two decades at mid-single-digit annual rates, with better pricing and product mix adding another couple percentage-points to top line growth each year, and profit margins doubling. In this scenario we think the stock is worth €200 per share today, or 60 per cent more than where it is currently trading.

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Said another way we think the market is underappreciating the runway for growth and the potential for improved profitability ahead of Airbus. The current share price of around €125 implies the market is taking a moderate view of production volumes than the industry requires, failing to recognise price/mix benefits, and consequently underestimating profit margin expansion over time.

* * *

In closing, on behalf of the entire Montaka team, I would like to thank each and every one of our investors for the trust you continue to place in us to preserve and grow your wealth over time. We continue to work tirelessly to deliver you attractive returns and a positive experience in your partnership with us. We seek the highest standards of discipline and integrity in how we operate, while continually looking for opportunities to improve our offering.

Sincerely,

Andrew Macken

Chief Investment Officer

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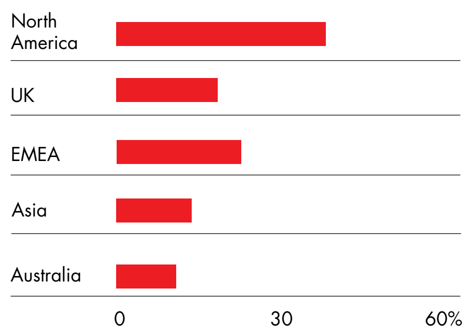
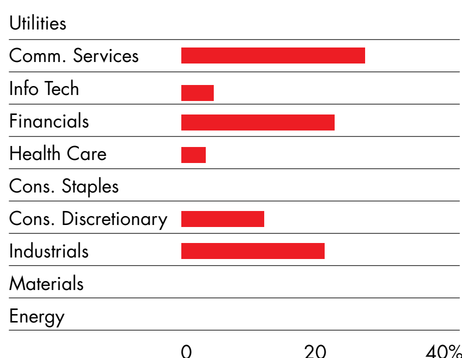
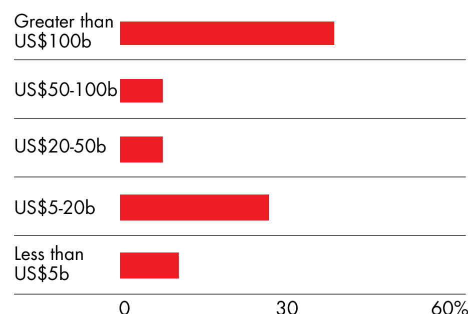
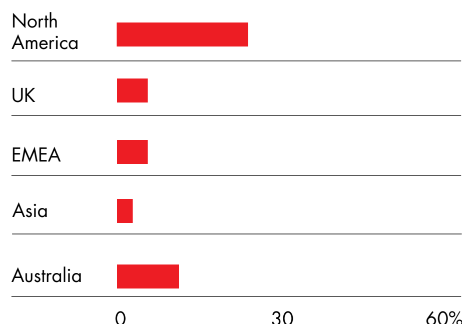
LONG PORTFOLIO (as at 30 June 2019)

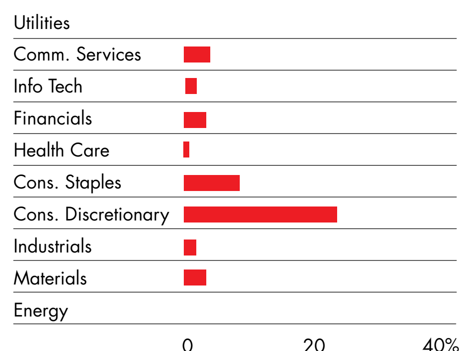


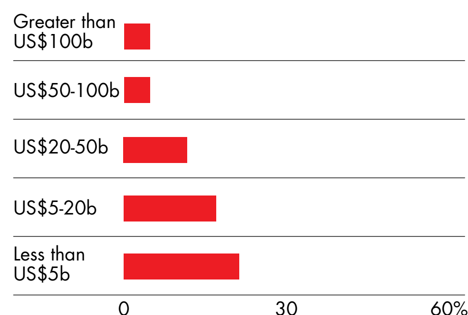




SHORT PORTFOLIO (as at 30 June 2019)







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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