Montgomery Small Companies Fund Annual Letter 2021

Dear Fellow Investors,

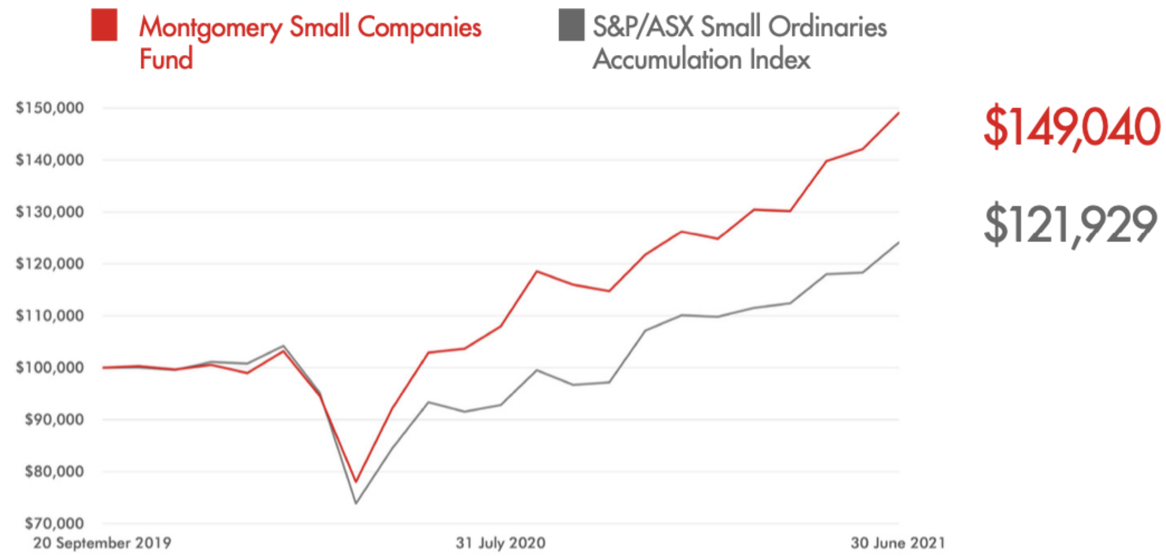
Welcome to the Montgomery Small Companies Fund (the Fund) 2021 Annual Letter.

On behalf of Dominic and I, we are truly grateful for your confidence and support. The wealth of our families are invested alongside yours.

<u>Performance and distributions</u>

In the year to June 2021 the Montgomery Small Companies Fund increased 43.8 per cent, while its benchmark, the Australian Small Ordinaries Accumulation Index increased 33.2 per cent. After all fees and expenses, the Fund outperformed the benchmark by 10.6 per cent over the year. Since inception, 20 September 2019, the Fund increased 49.0 per cent, outperforming the benchmark by 27.1 per cent, after fees.

Montgomery Small Companies Fund performance since inception



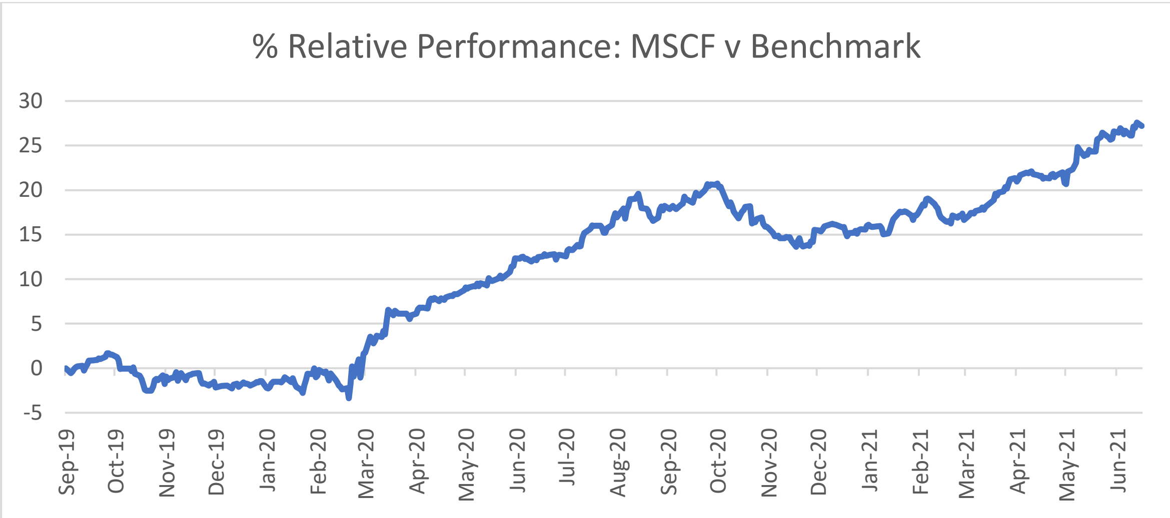
Source: Fundhost/ Montgomery

The Fund ended the year with a unit price of $1.4904, a distribution of 7.8912 cents was paid, and we start the new financial year with a unit price of $1.4115.

<u>2021 – The year in review</u>

Our core philosophy of actively managing capital and investing in the best of what we see in front of us drove returns over the year. The Fund averaged around 80 per cent active during the year – this means 80 per cent of the Fund's holding through the year were different from the shape of the benchmark. That is "normal" for us as we seek to put money to work in the best opportunities we can find, in a balanced and disciplined way.

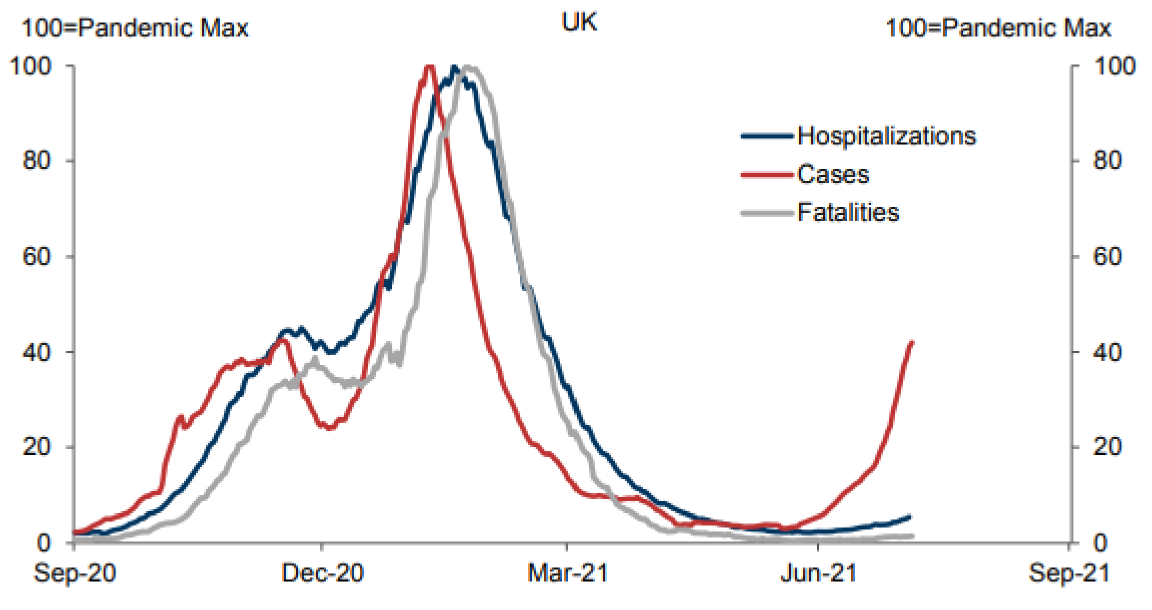
What is also normal for us is not to be wedded to any one investment style, and this was evident during Fiscal 2021. Market sentiment shifted (quite quickly) from growth to value around November 2020, reflecting the tough run of underperformance of value up to that point. The huge impact COVID-19 stimulus had on general economic activity lifted the short term fortunes of "value" stocks, along with the arrival of a 95 per cent efficacy vaccine. The speed of this market rotation initially caught us off guard; whilst we had been shifting the portfolio in that value direction, investing in stocks we thought would benefit from an eventual re-opening, we hadn't seen the 95 per cent vaccine event coming or its perceived impact in the shape of future economic activity as our central scenario. However, when facts change, we are happy to revisit our view so we quickly pivoted the portfolio towards more of those stocks benefitting most from that re-opening scenario, where we deemed valuation hadn't yet captured the improved outlook and where we found the level of risk acceptable. This is evident in the chart below which plots the performance of the Fund relative to its benchmark since inception.



Source: Montgomery

<u>Outlook</u>

Any outlook requires a baseline assumption for how we see COVID-19 playing out from here. In short, our base case assumption is that vaccines carry the day, and that human and economic activity adjust to a life living with the virus. We'll adjust our view to the nuance and details as they come into view, but the bottom line is that there is a future coming which looks a lot more normal. The chart below uses data from the UK to observe vaccine effectiveness in the face of rising cases (higher infectious Delta virus variant and increased social mobility driven). As can be observed in the data, cases grow, but hospitalisations and fatalities decouple from case growth, suggesting that vaccines are doing their job in a highly vaccinated population set. Of course, things could change, but that is what we see today (and if they change, we will react to that too).

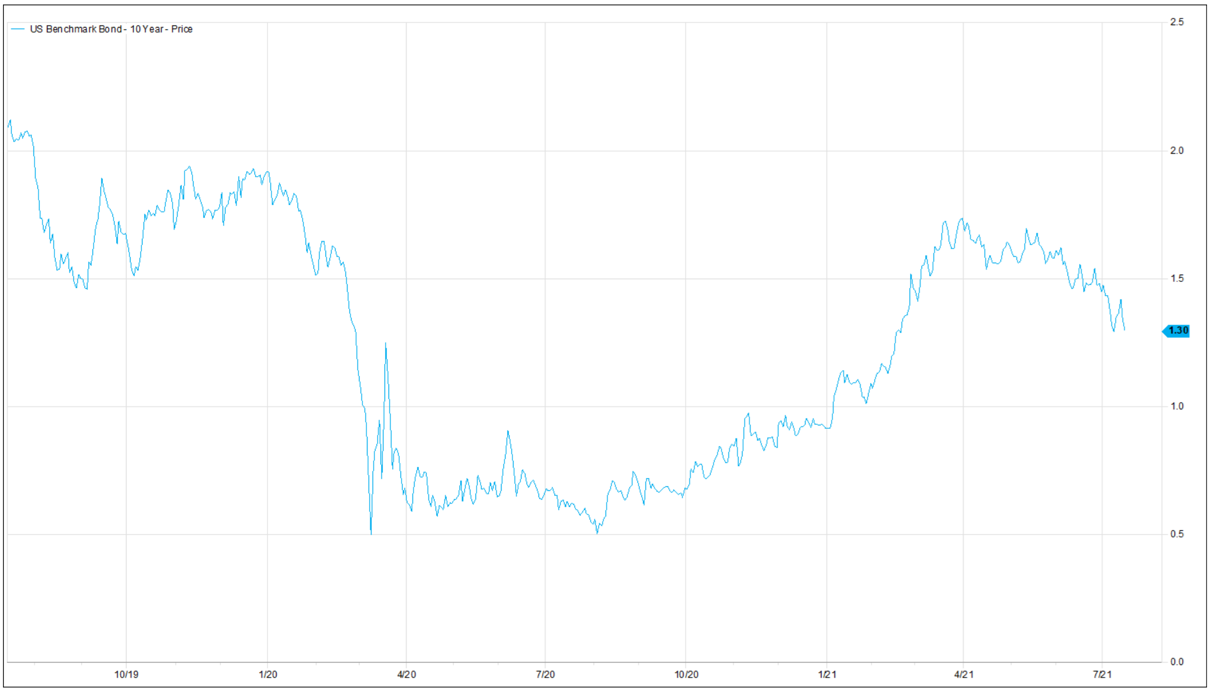


Source: JHU CSSE, ONS, Goldman Sachs Global Investment Research

Economic Outlook – Not too hot but just right…

The global economic recovery post the COVID-19 lows has been much stronger and more rapidly delivered than economic forecasters expected. As I write we are at the first anniversary of the trough in economic activity brought about by the initial global pandemic lockdowns observed through the June and September quarters of 2020. As a consequence, we are now passing through the point of peak global economic growth. This stands to reason as the bigger the trough, mathematically you are going to see the fastest growth rate on the smallest base. And that is happening about now.

That faster and stronger than anticipated recovery from the COVID-19 lows has given rise to rates of inflation not seen for some time, particularly in certain pockets of the economy where the supply side has struggled to cope with the rapid demand shock fuelled by synchronised central bank and government stimulus policies. That same mathematical effect is again at work, this time manifesting fears that inflation could spiral out of control (those forecasters again…). These fears appear to have dissipated somewhat as observed in a common barometer for inflation expectations, the yield on US 10-year government bonds.



Source: FactSet

Yields "peaked" at the end of March 2021 at 1.75 per cent, having risen from COVID-19 lows in July 2020 of 0.54 per cent. To provide some context, yields pre-COVID19 were at around 2.0 per cent, so we are still within the "tramlines" of the pre-COVID-19 world expectations.

Where to from here? In the short to medium-term we expect healthy levels of global growth as most large global economies continue the recovery journey back to pre-COVID-19 levels of activity. It won't be at the rapid growth rates experienced over the last year as we from the pandemic low.

The same for inflation. It would be strange after all for the truly epic-level stimulus deployed during COVID-19 not to deliver some higher level of inflation in the short to medium term. What we can't yet say is whether the longer-term impact of these stimulatory forces will sustainably overwhelm the factors that have delivered us a low growth, low inflation world we observed during the last decade. We don't expend our (very) limited brainpower trying to find the answers to big questions like these. Imponderable. Instead, we just invest with what's in front of us, stay nimble but remain aware of the direction of travel for, and market opinions of, those large imponderable macro forces. We can wait until we know more, and cross that bridge when we come to it.

In the meantime, we remain focused on finding those stocks that can make the most out of the prevailing economic conditions we can see, or better yet, those competitively advantaged businesses that will take market share and grow over the medium term independent of the prevailing macro environment. We are truly grateful that our investment landscape, small companies, is chock a block full of such opportunities. And we intend to make the most of that.

Portfolio positioning

We have one job; to deliver consistent outperformance for an acceptable level of risk. We do that by investing the Fund across multiple axes of opportunity, or themes; we don't want all our eggs in one basket no matter how attractive that basket may appear. Our objective is to avoid running the risk of getting it wrong. So, we have many themes and we highlight three here:

Normally we'd be grateful for one genuine multi-decade seismic shift in a trillion-dollar market, but today we have two that we can easily invest in in Australia – **Cloud** and **De-carbonisation**. We have a good but balanced exposure, complemented by numerous stocks that we anticipate will benefit from the post COVID-19 economic re-opening, as well as a range of other interesting themes and ideas.

Cloud: If you follow our monthly reports or website articles, you'll have heard us talk to the shift in favour of small companies generally that the emergence of Cloud Technology architectures brings. Long story short, cloud democratises access to technology; tech is no longer a competitive weapon wielded by the bigger market share holding incumbents. You no longer need to be a scale business to get the unit economics of technology cost low enough to be a positive competitive factor for your business. Today cloud allows all companies, big and small alike, to access technology on broadly the same cost and terms. Scale is no longer an advantage. In our view, large scale is a probable disadvantage; its innovation and nimbleness that count in today's world. A company with a good idea can prosecute it quickly using cloud tools – test it, fail and learn, and then work out when that optimal moment to scale into the market is and just go for it.

Intuitively we know that's happening out there in big markets today. Cloud, innovation and nimbleness, they all live in small companies. And we are invested in several stocks that are beneficiaries of these forces. From infrastructure players like Macquarie Telecom (ASX:MAQ) and NextDC (ASX:NXT), in the access layer with Megaport (ASX:MP1), or in software companies finding a new commercial platform to sell their IP as a service, and in the many companies directly using these technology tools to just be a more competitive business. We will be boring you all for years to come on this theme, and hopefully generating those consistent above-market returns too.

De-carbonisation: It is here and it is huge. Who would have thought a global pandemic that threatened millions of lives would be the catalyst for a huge acceleration in global De-carbonisation. But it has. Stimulus from western governments has been focused on facilitating change in sectors that can lower the carbon emission intensity of their economies; electric vehicles and energy storage sectors have had huge government led funding injections. Corporates are responding to a new wave of anticipated demand and the prospect of obtaining a leadership position in rapidly forming new markets with wave after wave of investment announced and commenced to support the "greenification" of their business models. Australia's role in this is pivotal, as an *independent* producer of materials that are key feedstock elements for these de-carbonising industries – Lithium, Copper, Nickel, Rare Earths and others are required in greater quantities to fuel this new energy revolution. Additionally, Australia has an opportunity to add value beyond the raw commodity production. Today, significant swathes of rare earth and lithium processing activity occurs in China. Western governments and large corporates no longer want to be beholden to Chinese controlled supply chains for these critical industry inputs, and many Australian corporates are stepping into that void. We have a range of investments across these commodity miners and processors that stand to benefit from both rising demand and the positive impact we expect that to have on commodity prices, particularly when that demand hits brittle supply, such is currently the case with Copper. This is a multi-decade theme and we expect to be investing here for many years.

Re-opening: Normal is coming, but there is a twist. Australia has done an amazing job at managing the COVID-19 risk on its citizens; we have all enjoyed a significantly higher quality of life in Australia than just about any other location in the world. But this has now become a (first-world) problem for Australia.

Almost all other locations in the developed world are going to see an improvement in the quality of life as the transition from the liberty-sapping horror experience at the depths of the pandemic to a vaccinated life living with its aftermath. Citizens of these countries understand what the downside of COVID-19 truly looks like, and broadly speaking are happy with the idea that vaccines allow them to achieve a more normal life co-existing with the virus. Liberties will be fully restored, hospitality and travel are back on. Whilst there will still be infections, hospitalisations and deaths as a result of co-existing with this virus, vaccines mean these will be much, much lower, but not zero.

On the other hand, Australia's journey to normal is going to be a slower one. We are coming from a less traumatic COVID-19 experience, and once vaccinated, borders will re-open and we too can re-connect with the rest of the world. However, our citizens will then be subject to COVID-19 circulating the world, with those same infection risks and likely outcomes outlined above, i.e. it is highly unlikely that infections, hospitalisations and death as a result of opening up will be zero. That's a tough but necessary sell to Australian citizens, our media here will do what they do best and amplify the negativity around this transition, to say nothing of the political implications.

This understanding is shaping how we are choosing to find opportunities in economic re-opening, and our bias is to take exposure in markets where the trajectory of re-opening is positive. For example, in travel and retail we have invested in stocks that have greater exposure to overseas re-opening, as opposed to domestic activity, to make the most of the more dramatic change in activity overseas but to also de-couple the portfolio as much as possible from the torturous re-opening politics happening here in Australia. If we are going to take re-opening risk, we'd like it to be worth it. That said, we are always looking for any shifts in sentiment that may deliver investment opportunities; it's a dynamic world and we want to exploit that.

Furthermore, when we are looking at re-openers, we want companies that have improved their competitive position during that COVID-19 downcycle. We are looking for stocks where the market is going to be surprised by that shift in earnings power as they benefit from that return of demand. Companies like Corporate Travel Management (ASX:CTD), with its 70 per cent exposure to US and UK travel, that have invested through the downturn and operate in large markets where competitors have struggled to cope with the downturn, look well positioned to take market share when the upturn comes.

Given the backdrop we are fully invested, cash sits at about 2 per cent as I write, and that is the normal level for us. Thank you for your time reading our Annual Letter, we look forward to sharing more content in the coming months.

Happy investing.

Signatures.