MONTAKA
GLOBAL ACCESS FUND

MONTAKA

QUARTERLY LETTER

SEPTEMBER 2019

UNIT PRICE [1] $1.0756

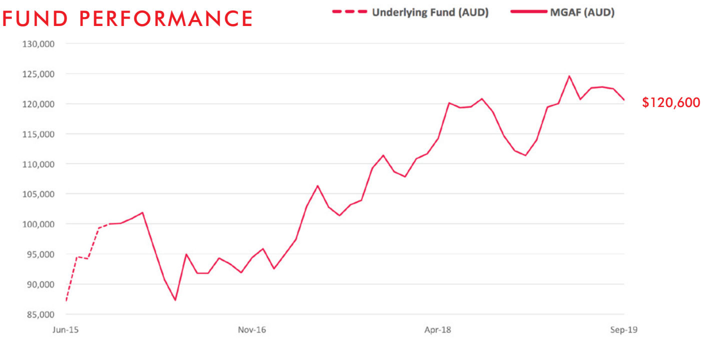
FUND COMMENTARY

In the month of September, the Montaka Global Access Fund (the Fund) declined by 1.50 per cent, net of fees. This brings the return for the September quarter to negative 1.65 per cent, net of fees. Since inception, the Fund has returned 20.60 per cent, net of fees, or 4.90 per cent per annum, delivered with an average net market exposure of 47 per cent.

In the quarter that transpired, we observed a continuation of many of the same dynamics that have been analysed in prior letters. We summarise them below for completeness while acknowledging that not much has changed with respect to the shapes of the probability distributions of possible outcomes for many of these global risks. We reiterate our goal to compound the wealth of our investors, alongside our own wealth, over the long-term. Many of the near-term twists and turns in the market are interesting, but not overly significant to our long-term objective.

Approaching the current deadline for Brexit, there remained no clear workable deal between the UK and the EU for how the separation will take effect. This could well change quickly, however. The most important point for equity investors, in our view, is that following Brexit, the UK will continue to exist. Life will go on. Businesses will continue to operate. And yet, the market-implied expectations built into many UK stocks today are pointing to a decline for near-eternity. We believe Brexit is throwing up a number of extraordinary opportunities which we are well-prepared to capture over time. These opportunities include Prudential (LSE: PRU) and St James's Place (LSE: STJ) – businesses which are well-positioned in structurally growing industries and will grow their earnings irrespective of the direction and timing of Brexit.

FUND PERFORMANCE



PERFORMANCE ATTRIBUTION[1]* (%)

	September 2019
Long portfolio contribution	0.45
Short portfolio contribution	(1.79)
Change in AUD/USD	(0.16)
Net return	(1.50)
Since inception[2]	20.60

EXPOSURES (as at 30 September 2019)

	% of NAV
Long exposure	100.1
Less: short exposure	(45.9)
Net market exposure	54.1

POSITION METRICS (as at 30 September 2019)

	Long Portfolio	Short Portfolio
Number of positions	18	32
Largest position size	7.6	3.1
Smallest position size	3.3	0.6
Average position size	5.6	1.4

Note: sizes shown as % of NAV

TOP 10 LONG POSITIONS (as at 30 September 2019)

		% of NAV			% of NAV
1	Vivendi	7.6	6	Microsoft	6.3
2	Insperity	7.5	7	Apple	6.1
3	Prudential	6.6	8	Facebook	5.8
4	Floor & Decor	6.3	9	Airbus	5.7
5	Alphabet	6.3	10	Alibaba	5.6
Total top 10 long positions					63.9

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

Montaka Global Fund	174.4
of which: Montaka Global Access Fund	71.6

PERFORMANCE (%)	1M	3M	12M	2 Yr pa	3 Yr pa	COMPOUNDED ANNUAL RETURN SINCE INCEPTION	SINCE INCEPTION
Fund (AUD)[2]	**(1.5)**	**(1.7)**	**1.7**	**7.7**	**8.9**	**4.9**	**20.6**
Underlying Fund (AUD)[4]	(1.5)	(1.7)	1.6	7.7	8.9	7.9	38.2
Average Net Market Exposure	54	50	48	46	47	47	47
Global Market (AUD)[2,5]	2.0	4.6	9.2	14.8	14.9	10.2	46.1
Average Net Market Exposure[3]	100	100	100	100	100	100	100

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, 7.4407 cents 30/06/2018 and 2.9395 cents 30/06/2019.
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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The trade dispute between the US and China continued to escalate. We choose not to provide a blow-by-blow account of the most recent developments except to say: (i) the US and China remain far apart on a number of fundamental ideological issues and this probably will not change for the foreseeable future; (ii) the trade war is clearly hurting the Chinese economy and has now started to impact the US economy; and (iii) President Trump, who is now likely to be impeached over the coming months, is facing a difficult re-election process in 2020 – a process which will be made more difficult against the backdrop of a deteriorating economy. We see a high likelihood that President Trump will seek to jump-start the US economy and equity markets next year by relaxing tariffs and announcing an "impending" trade deal.

The situation in Hong Kong remains a particular focus of ours. Putting aside a discussion on the value of freedom, the equation for equity investors is that Hong Kong represents a low probability, high consequence risk. One can paint a nasty narrative around how the situation could potentially play out: Beijing cracks down on Hong Kong, the US retaliates, capital flows between Hong Kong and the Mainland are suspended, the solvency of the Hong Kong banking system is called into question and we enter into a new Asian financial crisis. While such a scenario is possible – and has increased in likelihood in recent months – we still believe the probability of such a scenario remains low.

From a global economic perspective, it is true that the Chinese and European economies have weakened in recent months. Indeed, even the US economy has started to experience some pockets of weakness related to its trade dispute with China, but generally remains healthy. Against this backdrop, global monetary policies have moved to an easing bias and are supporting leading indicators which are pointing to global stabilisation over the coming months.

From an equity perspective, we continue to observe a high degree of bearishness amongst global investors. It is easy to point to many of the global risks flagged above and conclude that equities are unusually risky today. We believe investors are underestimating the potential for more optimistic scenarios, however. Consider how equities would perform in an environment of easy monetary settings, a stabilised global economy, an acceptable Brexit deal and relief from US trade measures while President Trump seeks re-election. Such a scenario, while far from certainty, is far less improbable than most currently believe, in our view.

The point is that investors need to remain invested. We believe our strategy of owning high quality, structurally growing, global businesses that remain undervalued will deliver strong compounding over the long-term. Short-term risks need to be managed but should not distract from the power of long-term compounding. We believe our portfolio of carefully selected short positions helps manage many of these short-term risks.

One such short position is Pearson (LSE: PSON). We have been short this name for more than a year and we believe the thesis has now started to play out. In the case study below, Amit Nath summarises our thesis on Pearson.

CASE STUDY: PEARSON

Pearson's origins date back more than 200 years when it started out as a construction company, before pivoting into the then promising field of publishing a century later. Pearson was, at one point, the world's largest book publisher. At the time, book publishing was regarded as a wonderful business with high barriers to entry, low competition and few substitutes. In fact, printed books were the primary instrument for structured knowledge transfer, learning and entertainment for generations of people.

Unfortunately for Pearson, with human advancement comes attrition, and book publishing has suffered significantly with the rise of television, film, video games and, of course, the internet. These new media channels pull people's focus away from traditional paper-based reading or completely replace it altogether.

Perhaps the last bastion of hope within book publishing that continues to hold a significant printed presence is education. So it is not surprising that Pearson has evolved into the world's largest education business. While education has been central to human advancement for thousands of years, and is unlikely to change anytime soon, Pearson does not have a value-accretive claim over this theme and is ironically being disrupted by it.

Pearson presents itself in an unnecessarily complex manner, with management dividing the business into 26 divisions scattered across approximately 70 countries. In our view, however, Pearson can be considered in terms of four basic business activities.

1. Provision of courseware (e.g. university textbooks);
2. Assessments (e.g. student exams, professional accreditations);
3. Distance Learning (e.g. online courses); and
4. English Services (e.g. teaching, certifications).

Importantly, two-thirds of Pearson's aggregate revenues are in decline, with the balance exhibiting some growth. As can be seen from the chart below, in 2018, U.S. Higher Education Courseware represented 28 per cent of Pearson's revenue and declined by 5 per cent; whereas Distance Learning represented 18 per cent of revenue and grew by +6 per cent. Overall however, Pearson expects the two-thirds of its revenues that are in decline to continue contracting at around 4 per cent per year, counterweighted by the remaining third of revenues which are expected to grow at around +7 per cent per year. At this cadence, Pearson's revenues will have grown by a miniscule +2 per cent in five years and, as we discuss later, profitability is expected to decline by 10 per cent over the same period.

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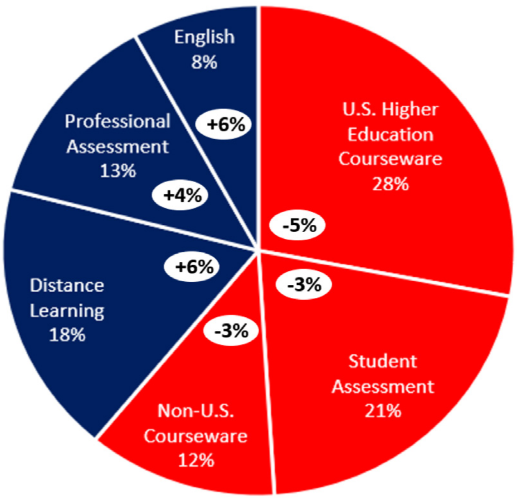
Revenue by Business Activity and Underlying Growth (2018)



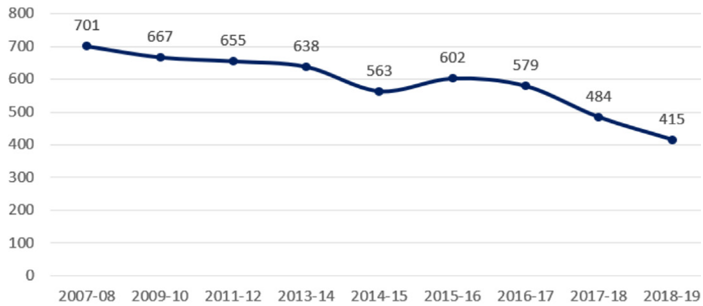
Source: Company filings, Montaka Global

Over the last several years, the education publishing industry has undergone a secular transition from analog (print) to digital – not too dissimilar to the shifts forced upon other industries like music (CDs to streaming), television (broadcast to on-demand) and novels (paperbacks to eBooks). While Pearson is the largest textbook publisher in the world with approximately 40 per cent market share in the U.S., the business is in secular decline. Meanwhile, the internet has given birth to hundreds of competitors that are challenging the traditional firms by offering digital education resources that are high quality, low-cost or even free, which are replacing legacy teaching materials. As traditional education courseware is disrupted, the incumbent operators are seeing their businesses diminish as the pie is shared by a larger universe of players. In parallel with this, numerous alternative channels for traditional textbooks have emerged, including rental, second-hand and counterfeit, which has created an efficient secondary market. Such a vibrant secondary market further reduces demand for new textbooks and exacerbates the secular decline the industry is already facing.

Pearson's U.S. higher education (i.e. university) courseware division is its most challenged business as it generates at least 50 per cent of its revenue from print textbooks, which are declining at a double-digit rate, as students move towards more cost-effective options. Compounding this headwind is the fact that print is being replaced by online offerings, a channel in which significant competition has emerged. Even though online education is growing (as print declines) and Pearson expands in this area, it is only one-third as profitable for Pearson as the legacy textbook publishing business. In fact, at Pearson's growth cadence, it will only increase revenue by 2 per cent over five years in exchange for a 10 per cent decline in profit – the very definition of profitless growth. Adding a further headwind to this outlook is the potential for a sharp rebasing of textbook pricing in the near-term, which would materially compound the expected contraction in earnings.

U.S. higher education enrolments have been falling by 1-2 per cent each year for nearly a decade with the amount each enrolled student spends on courseware exhibiting an even sharper secular decline. Based on the latest numbers from the National Association of College Bookstores (NACB), students spent an average of $415 on new and used courseware in the 2018-19 academic school year, which represents a staggering more than 40 per cent reduction over the last decade, as students find substitutes and technology driven price deflation prevails.

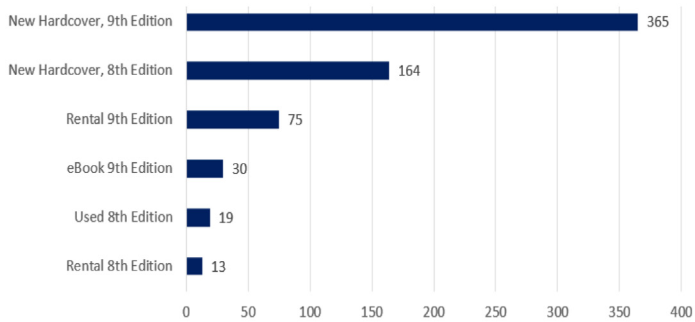
Average Student Spend on Higher Education Courseware (US$)



Source: National Association of College Bookstores

We also looked at an interesting "real world" example of what the textbook value proposition currently looks like from a student's perspective (i.e. Pearson's key customer). One of the most expensive books in the Pearson library is "Astronomy Today" by Eric Chaisson and Steve McMillan. A new copy of the 9th Edition of the textbook costs $365 from a bookstore. If a student can make do with the eBook, however, they could save themselves more than 90 per cent with a cost of $30. Given some students prefer a physical copy of their texts, the 9th Edition is also available to rent for $75 for the semester, an 80 per cent discount to purchasing it. A thriftier student may even opt to rent the previous 8th Edition, which can be done for just $13 per semester, a more than 95 per cent discount to ownership of the latest edition. Given the level of price deflation visible in the textbook channel, it is not surprising that the industry is in secular decline particularly given the cost of creating the content (mainly paying the authors) has not changed materially.

Price of New, Used and Rental Versions of Pearson's "Astronomy Today" (US$)



Source: Chegg, Amazon, Barnes & Noble, Montaka Global

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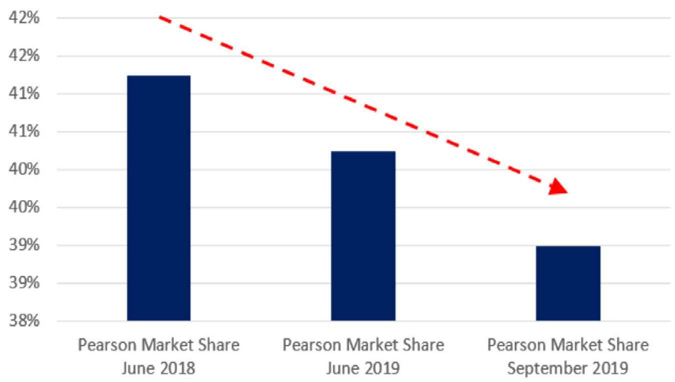
In August 2018, the second largest player in U.S. higher education courseware, Cengage, launched a disruptive textbook proposition for students, called Cengage Unlimited. The program offers unlimited access to all of Cengage's approximately 22,000 eBooks, online assignments, study guides and low-cost print rentals for $120 per semester or $180 per year. Cengage Unlimited has the potential to be significantly deflationary for courseware pricing, given the average new textbook costs $120 each. Take for example, if a student had four classes which prescribed Cengage courseware, the student would save $360 per semester with the effective price of courseware marked down by 75 per cent (i.e. students pay $120 and receives $480 worth of value). In its first year (2018-2019) over one million students subscribed to Cengage Unlimited, with Pearson's market share of higher education courseware precipitously falling during that time.

Pearson U.S. Higher Education Courseware Market Share (2019 vs 2018)



Source: Broker Research

An additional headwind for courseware pricing is the proposed merger between Cengage and McGraw Hill, the number two and three players behind Pearson. The merger would see the amount of content available under Cengage Unlimited double, broaden the number of university courses that would benefit from the program and magnify the already compelling value proposition for a student.

A summary of our short thesis on Pearson is provided in the table below using our Montaka short-side framework that will be familiar to many readers. With respect to valuation, the market continues to embed an extremely optimistic scenario for the company and despite Pearson recently slashing its profit guidance, sending the stock sharply lower, we still see significant downside. After more than 100 years in the publishing business, Pearson might need to hit the books and find itself a new line of business (again!).

Summary of Montaka short thesis on Pearson

	Drivers
Structural Themes	• Education transition from analog (print) to digital • Significant new competition in online education • Print textbooks in structural decline
Divergent Expectations	• Market-implied earnings expectations too optimistic
Asymmetries	• High chance of price (and margin) reset downwards
Misperceptions	• Earnings boosted by temporary cost-cutting • Divergence between reported profits and cash receipts

Source: MGI; Bloomberg

* * *

In recent weeks, global equity investors have observed yet another sharp rotation between sectors. As is usually the case, what followed was a lot of discussion about the reasons for the sudden rotation. Why does "value" outperform "growth" all of a sudden, after underperforming for so long? And what will outperform next week and the week after?

We view the analysis of such "factors" in the attribution of equity returns as interesting, but not particularly helpful. As we, and others, have pointed out before: there are many forces that can move cohorts of stocks over short periods of time. From quant funds, to passive exchange traded funds, to central banks buying equities. We simply do not see the point in trying to predict or chase such short-term rotations in global equity markets.

We believe substantially all of our investors would share the above philosophy. But the cost of such a philosophy is some increased variability in month-to-month returns – especially when compared to various forms of the global equity index.

This is why a long-term perspective is so important. For many of our investors, we are not just managing their wealth; we are managing the wealth of future generations to come. Through this lens, what will ultimately matter is the identification and ownership of tomorrow's great global businesses. And what rapidly diminishes in importance are short-term rotations and distractions.

* * *

From a business perspective, we welcomed two new employees to the Montaka team during the quarter. Phill Namara joins our research team on a part-time basis as he completes his double-degree in Actuarial Studies and Finance. And Aafy Awad joins our Distribution team to help coordinate our marketing initiatives.

As we move into the final quarter of calendar 2019, I would like to take this opportunity to once again thank each and every one of our investors for the continued trust you place in our investment process and our team. We continue to work tirelessly each and every day to achieve our goal of preserving and compounding your wealth, right along side our wealth, over the long term.

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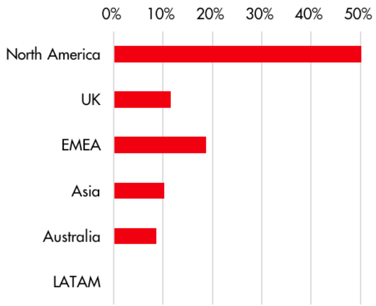
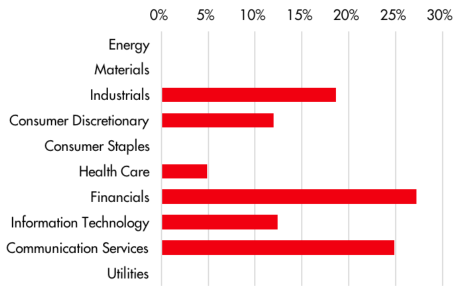
LONG PORTFOLIO (as at 30 September 2019)

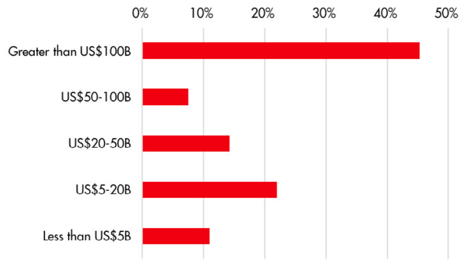
GEOGRAPHIC EXPOSURE
(Country of domicile)



INDUSTRY EXPOSURE

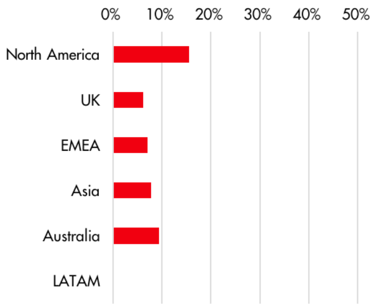


MARKET CAP EXPOSURE

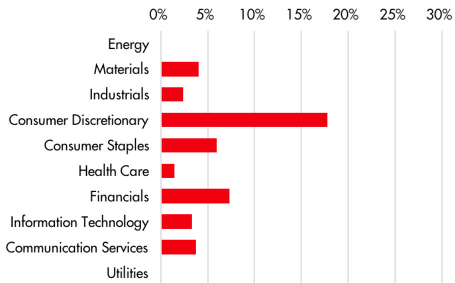


SHORT PORTFOLIO (as at 30 September 2019)

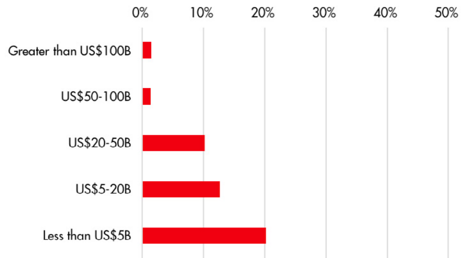
GEOGRAPHIC EXPOSURE
(Country of domicile)



INDUSTRY EXPOSURE



MARKET CAP EXPOSURE



Note: exposures shown as % of NAV

INVESTMENT MANAGER

MGIM Pty Ltd
Authorised Representative No: 001007050

Suite 7.02, 45 Jones Street
Ultimo NSW 2007

Telephone: +61 2 8046 5000

WHO DO I CONTACT?

For direct investors, please contact
David Buckland at dbuckland@montinvest.com

For advisors, institutional investors and consultants, please contact
Scott Phillips at sphillips@montinvest.com

Telephone: +61 2 8046 5000

David Denby at ddenby@montinvest.com