THE MONTGOMERY [PRIVATE] FUND

Annual Letter to Investors

July 2021

MONTGOMERY

To our Investors:

July 2021

Dear Investors,

The Montgomery [Private] Fund (The Fund) recorded a 28.36 per cent total return for the year ending June 30 2021. The Fund's benchmark, the S&P/ASX 200 Industrials Accumulation Index, generated a materially lower return of 10.68 per cent for the same period, while the broader market, as measured by the S&P/ASX300 Accumulation Index, returned 28.49 per cent.

Over the last two financial years, The Fund has returned 22.60 per cent, outperforming both the negative return of 3.31 per cent generated by The Fund's benchmark over the same period, and the 18.71 per cent generated by the broader S&P/ASX 300 Accumulation Index over the same period.

Importantly, The Fund has delivered its outperformance with less volatility and with no exposure to resource stocks, which collectively were a significant driver of the market's gains.

Instead, The Fund had established the largest position it has ever held in the banking sector. More on this later.

The 2021 financial year produced strong returns across most asset markets stretching from equity, property and commodities all the way to second hand vehicles. Amid a combination of extremely accommodative monetary policy and receding risk from, and accelerating growth out of, the COVID-19 pandemic, investors have been willing to pay more for a dollar of future earnings.

Distribution

The size of the distribution for The Montgomery [Private] Fund tends to be driven by realised gains and losses more than by dividends or interest income. Therefore, full year distributions can vary considerably from year to year, depending on which holdings have been sold and whether a gain or loss was realised on each.

You should note that our approach in managing The Fund is not to aim for a particular level of distribution, but to aim for the best possible risk-adjusted return.

Over the ten and a half-year life of The Fund, distributions have totalled 86.3401 cents per unit, which equates to an annual average 8.2 cents per unit or 8.2 per cent per annum on the $1.00 unit price at inception.

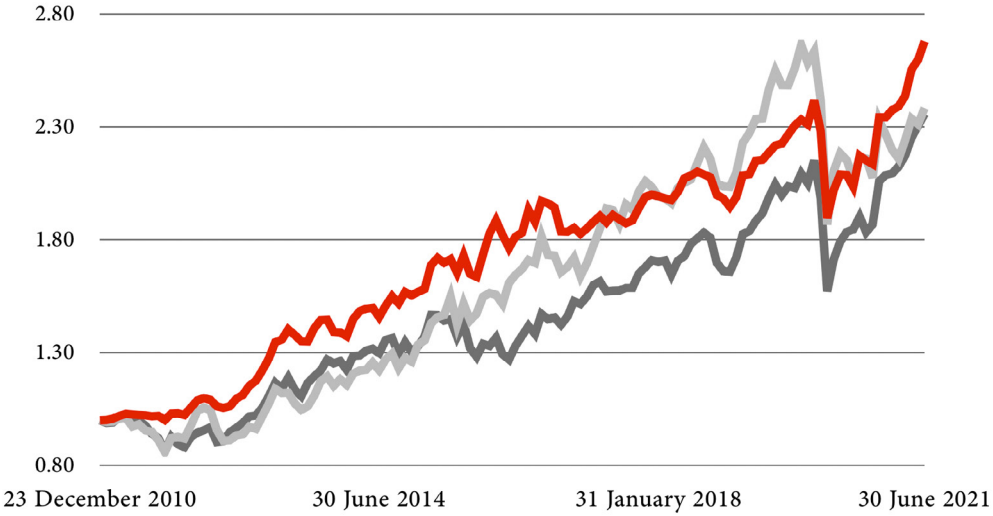
The distribution at 30 June 2021 was 6.2857 cents per unit, and so after ending FY 2021 with a unit price of $1.4236, we commence FY 2022 with a unit price of $1.3608.

Table 1: Distribution History for The Montgomery [Private] Fund to 30 June 2021

Year to June	Distribution (cents per unit)
2012*	2.8771
2013	12.8334
2014	4.4934
2015	14.6151
2016	17.2143
2017	6.1093
2018	12.0517
2019	6.0173
2020	3.8429
2021	6.2857
Total	86.3401

*23 December 2010 to 30 June 2012

Figure 1. The Montgomery [Private] Fund Cumulative Performance



Source: Fundhost/ Montgomery

Table 2: Annual Performance Information

	Returns					Maximum Drawdown			Annualised Volatility		
Period	The Montgomery [Private] Fund	S&P/ ASX 300 Accum. Index	Relative Performance	S&P/ ASX 200 Industrials Accum. Index	Relative Performance	The Montgomery [Private] Fund	S&P/ ASX 300 Accum. Index	S&P/ ASX 200 Industrials Accum. Index	The Montgomery [Private] Fund	S&P/ ASX 300 Accum. Index	S&P/ ASX 200 Industrials Accum. Index
2011*	2.3%	-2.3%	4.6%	-4.4%	6.7%	1.7%	10.1%	10.5%	2.7%	13.2%	14.9%
2012	3.2%	-7.0%	10.2%	-4.8%	8.0%	4.2%	15.8%	16.3%	6.7%	19.1%	20.0%
2013	28.0%	21.9%	6.1%	15.0%	13.0%	6.3%	10.6%	11.3%	10.6%	11.5%	14.3%
2014	8.0%	17.3%	-9.3%	16.8%	-8.8%	9.2%	6.4%	8.6%	9.8%	11.1%	12.7%
2015	13.5%	5.6%	7.9%	16.5%	-3.0%	4.6%	8.6%	9.8%	9.2%	13.0%	13.4%
2016	13.6%	0.9%	12.7%	19.2%	-5.6%	7.6%	14.1%	8.6%	12.2%	18.5%	15.8%
2017	1.6%	13.8%	-12.2%	13.7%	-12.1%	9.4%	6.5%	11.9%	9.0%	10.9%	12.6%
2018	9.2%	13.2%	-4.0%	7.1%	2.1%	2.7%	5.1%	8.5%	5.8%	8.9%	11.1%
2019	4.8%	11.4%	-6.6%	19.2%	-14.4%	8.7%	13.0%	10.1%	9.6%	11.1%	11.5%
2020	-4.5%	-7.6%	3.1%	-12.6%	8.2%	28.4%	36.2%	40.5%	23.7%	28.2%	30.4%
2021	28.4%	28.5%	-0.1%	10.7%	17.7%	4.2%	5.4%	10.4%	11.5%	14.1%	17.3%
Since Inception	**9.8%****	**8.5%****	**1.3%****	**8.6%****	**1.2%****	**28.4%*****	**36.2%**	**40.5%**	**11.5%**	**15.4%**	**16.7%**

*2011 is the period 23 December 2010 to 30 June 2011
**Compound Annual Returns
*** Annual drawdown figures show the maximum decline within the relevant year
Returns are net of fees and assume all dividends are reinvested

2021 market performance

The 2021 financial year produced strong positive returns for most asset classes, and Australian equities were no exception. The broader market, as measured by the S&P/ASX 300 Accumulation Index, generated a total return of 28.5 per cent and all major sectors generated positive returns.

Having recovered strongly from its pandemic lows by the end of June 2020, the market largely treaded water for the first four months of FY2021, rising less than two per cent. But aggressive fiscal and monetary stimulus eventually found their way into the wallets of locked-down workers through cash handouts. Unable to spend on entertainment or travel those dollars were directed towards discretionary retailers whose shares steered the market's initial bounce.

A major milestone was visible in November 2020 with the release of Phase III clinical trial results from the most advanced and promising vaccine candidates. While investors were hopeful of at least one vaccine candidate achieving their primary endpoints for efficacy and safety, they soon learned all three were successful.

The impact on markets globally was immediate. Realistic hopes of reopening economies coincided with unprecedented government support and excessive levels of liquidity provided to the monetary system by central banks. Financial assets roared in November, and investors began rotating out of COVID-19/lockdown winners into the then beaten up, cyclical, COVID-19 losers.

Most commodities and 'speculative' assets joined equities, rallying hard over ensuing months.

Of course, investor sentiment swings wildly, and unbridled optimism about economic recovery morphed into concerns about inflation. Anxiety about unprepared and constrained supply chains as well as declining unemployment weighed on the fears of nascent inflation and fabricated concerns the forty-year period of low and accommodative inflation rates could be over.

Resources stocks, of which The Fund has virtually no exposure, finished the calendar year strongly. Metal prices rose to record levels. Iron ore was particularly strong, driving index-heavy BHP, Rio Tinto and Fortescue Metals materially higher. In the six months to June 2021 however, the performance of materials stocks moved back into line with the broader market.

In 2021, with economic momentum accelerating and the outlook for credit losses fading, it was the turn of the major banks to lead the market higher. In anticipation The Fund established the largest position in banks it has ever held. Our anticipated improvement in the pricing power of the banks proved to be more robust than the market had expected. The repricing of deposit rates offset a drag from falling returns on liquid asset holdings and the persistent front book to back book pressure on average lending rates. By the end of the calendar 2020 year, the market had pivoted a 180-degree on its outlook for credit losses.

Expectations flipped to anticipating write backs of loss provisions and a return of excess capital to shareholders. The banks collectively generated a total return of over 25 per cent in six months to June 2021, well ahead of the 13 per cent return generated by the broader market.

Longer-duration 'growth' stocks – those with hoped for profits – fell out of favour in the March 2021 quarter as bond rates increased on inflationary fears. While technology stocks were hurt during this period, the move largely reversed in May and June along with abating inflationary fears.

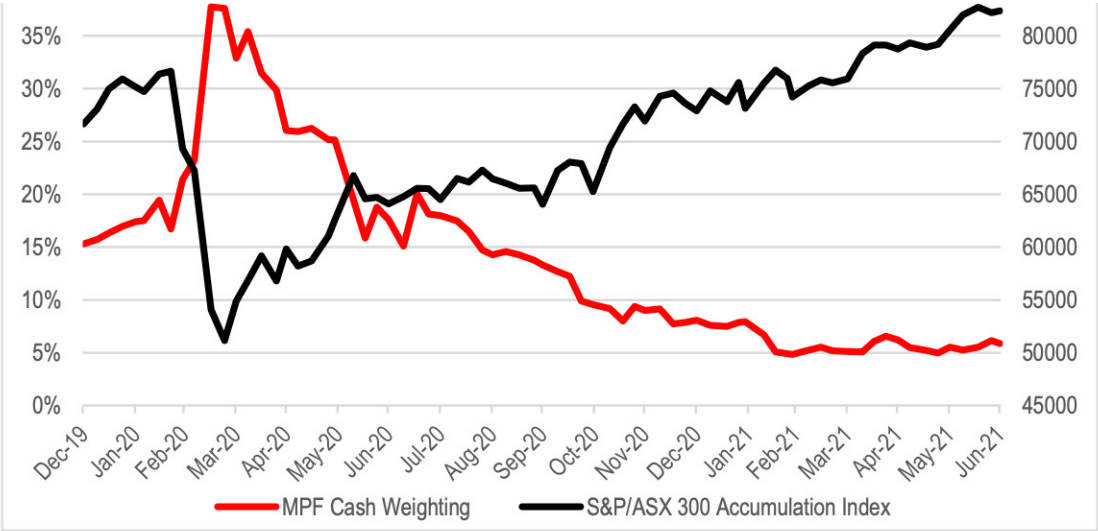
The customary period of volatility in May and June – 'confession season' – threw up far fewer profit warnings than is typical and this was due primarily to strong economic conditions and a high level of consumer spending supported by government largesse. The lack of profit warnings suggests strong earnings growth will be announced by many companies during the forthcoming reporting season.

Review of The Fund's performance

Having significantly reduced cash levels late in the 2021 financial year, the cash weighting was further reduced to take advantage of improved valuations and the outlook for risk.

Between 2016 and 2019, cash was almost entirely responsible for the drag on performance. During that period the portion of the portfolio that was invested did well. Too much cash was the issue. The COVID-19 disruption to markets and economies has simply allowed us to put the cash to work, and consequently, cash levels in The Fund have fallen to their lowest level in a very long time. Backing the investment team to invest is a logical decision given their stock picking expertise. Consequently, The Fund's performance has leveraged the strong returns of the companies selected.

Figure 2: The Montgomery [Private] Fund Cash Weighting vs the S&P/ASX 300 Accumulation Index



Source: Bloomberg

The high cash levels held at the beginning of the COVID-19 crisis in 2020 reduced the downside risk of The Fund but more importantly, the reduction in cash since then has improved the upside capture of The Fund, particularly over the last six months of the 2021 financial year.

The Fund also benefitted from both the August and February reporting seasons with few portfolio companies disappointing relative to expectations, and most producing very good or excellent results. Standouts included Reliance Worldwide, Codan, Tabcorp and Universal Stores.

Toward the end of the August 2020, we examined the evidence pertaining to COVID-19 vaccine trials and concluded the market was broadly overpricing so called "COVID-19 winners" – those companies benefitting from lockdowns and travel restrictions – while under-pricing companies that would benefit from a shift towards normality – the 'reopeners.'

This led to our decision to increase The Fund's exposure to the major banks as well as the travel company Webjet. The timing proved fortuitous with the market subsequently rotating aggressively into reopening companies following successful vaccine trials. Additionally, bank shares were the strongest major sector during the financial year and our largest ever position in the banks benefitted investors in The Fund.

As we have noted in the past, the broad market indices have a relatively large exposure to the banks at slightly over 20 per cent. Were we to match the market's exposure to the banks and allocate 20 per cent of The Fund to them, it would constitute a neutral position. Banks can be defensive investments in benign economic conditions. But as was highlighted by the Global Financial Crisis, as well as the sell-off at the initial stages of the pandemic, when economies go into recession, banks become 'hyper-cyclicals' due to their leveraged exposure to property prices and business risks.

This asymmetric risk also leads reliably, however, to strong share price performances when risk dissipates. This is precisely what The Fund experienced over the nine months to June 2021.

As was the case in the 2020 financial year, portfolio activity was higher than normal in 2021. Amid a fickle and potentially capricious market and risk environment, we added a number of new companies to the portfolio. They included:

- Webjet – Well-known as an online travel agent in Australia, Webjet is now a global hotel bed intermediary. While the COVID-19 pandemic saw volumes grind to a halt, it provided the company with the opportunity to invest in automating its business model. This step-change investment will see it operate on a lower and more scalable cost base once travel resumes, while also significantly strengthening its economic moat and competitive position.
- Universal Stores – A youth streetwear retailer listed in November 2020. The company has a strong management team, a long store rollout runway and earnings growth from a combination of existing store optimisation, online sales growth and investment in its supply chain.
- Capricorn Metals – A junior gold miner (a sector we last invested in approximately eight years ago) Capricorn is in the process of commissioning and ramping up its Karlwinda gold mine. The share price implies an excessively elevated risk premium given the quality of the project and experience of the management team.
- Coles Group – The second largest food retailer in Australia, Coles has lost market share during the pandemic due to its weaker online product, and relatively large exposure to CBD and mall-based store sites. We expect it to regain share as conditions and consumer activity progressively normalise.

- Pointsbet – Is the Australian sports betting company that has positioned itself to become a meaningful player in the rapidly opening US sports betting market. The prospects for the business improved materially following the announcement of an agreement with NBC Sports, which turbo-charged its ability to build its brand and acquire new customers.
- Resmed – The market leading provider of devices for the growing sleep apnoea market. Resmed is a very high-quality company The Fund has owned previously. The competitor's recent product recall will provide Resmed with a material step-up in market share for a number of years.

Earlier in the financial year smaller positions in Aristocrat Leisure, Magellan and National Australia Bank were sold to make way for an improvement in the overall quality of the portfolio.

During the year, The Fund also exited its investments in:

- Redbubble, Accent Group and Scentre Group as the investment had met or exceeded our expectations and the combination of remaining value and prospects no longer warranted exposure.
- Reece – while a very high-quality company, the share price is factoring in a very optimistic outlook for its Australian business, as well as the growth opportunity for the newly acquired US business.
- Invocare – due to the potential for a material rebasing of expectations given the renewal of the senior executive team.

While the cash weight has been materially reduced to circa five per cent at the time of writing, the process took some time, resulting in an average cash weight during the year of 9.5 per cent.

Any detraction to performance for the year relative to the broader market (about three per cent on a relative basis) can be attributed to this average cash weight.

Similarly, our relative underweight positions in both the materials and banking sectors made outperforming, which we did, tougher. Fortunately, as previously mentioned, we responded quickly to the improved attractiveness of banks stocks.

Drivers of performance in the 2021 financial year

Given the strong returns in the financial year, it is not surprising that there were a large number of contributors to performance during the year.

For the second year in a row, the largest contributor to the investment return was The Fund's investment in metal detection and communications company Codan. The Fund's average purchase price is $2.86 and at the time of writing the share price sits at $17.14, with the company benefitting from strong demand for its core metal detector lines, and the successful launch of a consumer line of products. Codan has also employed some of its excess capital to make two acquisitions in its Communications division, whilst retaining a net cash position on its balance sheet. The acquisition of Domo Tactical Communications and Zetron in February and April respectively, came at a cost of A$173 million and will boost group earnings by over 10 per cent.

The next largest contributor was Reliance Worldwide. Reliance had misstepped a couple of times in recent years, and the pandemic gave the market another excuse to mark down its share price, believing the company would be negatively impacted by COVID-19. This gave us the opportunity to increase the Reliance weighting at the end of the 2020 financial year, and we were almost immediately rewarded with both a strong result and a strong outlook statement released in August 2020.

Adoption of Redbubble's online platform accelerated amid greater awareness by locked down consumers. The consequent step-up in sales however was always going be difficult to repeat without a material increase in investment. A significant price increase combined with now greater uncertainty surrounding the success of the company's investment in maintaining growth made the decision to exit a relatively easy one.

Reece is a highly regarded company we have admired for a long time. Its customer-centric model focused on trade, and its differentiated product offering, have been delivering market share growth for years in Australia despite attempts to thwart it by Bunnings. The pandemic-panicked market, combined with a capital raising provided The Fund with the opportunity to acquire shares in the company at an attractive price. And while it's a good problem to experience, the share price increase over the following ten months pushed the shares to eyewatering earnings multiples. Consequently, we sold the position to reinvest in opportunities with more attractive risk/return metrics.

Other holdings that generated strong contributions during the year included Universal Store Holdings, Westpac, Accent Group and Tabcorp.

On the downside, there was only one holding that disappointed. Avita Medical is a company we have held for several years and in previous periods has contributed impressively to returns. We remain convinced Avita has intellectual property that will become the standard of care for burns patients. During the year, the company was negatively impacted by the COVID-19 pandemic. Restricted movement resulted in fewer serious burns, as well as limited opportunities to train surgeons and nurses on RECELL. This was frustrating as the roll out of RECELL was just beginning to gather momentum prior to COVID-19.

The pandemic further inhibited the company's recruitment of patients for its vitiligo, wound care and paediatric trials.

The share price was also affected by a couple of 'own goals' with the company electing to move the primary listing from the ASX to NASDAQ in the middle of 2020 and this saw retail investors in Australia exit the stock placing pressure on the share price. The selling pressure was compounded by the stock falling out of the S&P/ASX 200 in October 2020, and then from an equity raising in February 2021.

The positives were the company receiving US FDA (Food and Drug Administration) approval for burns covering more the 50 per cent of the body, as well as full-thickness burns and paediatric burns. Together these expand the size of the company's addressable 'on-label' market in the US by 50 per cent.

Toward the end of the 2021 financial year, as economies began to reopen, sales results demonstrated the company was regaining momentum. Accelerating sales growth, in combination with a growing range of FDA approved uses, provides us with confidence and optimism.

We believe, inevitably, the quality of the company's technology and intellectual property will eventually be recognised by other investors. In the absence of such recognition, we believe the company will be acquired by a larger distributor of medical devices.

The Montgomery [Private] Fund portfolio

We remain circumspect towards companies reliant on the economy reopening, including tourism, migration, travel and hospitality companies. Exposure to these industries needs to be primarily focused on overseas markets reopening rather than Australia.

IDP Education and Universal Store appear to have some exposure, however it is less than at first blush. Our main exposure to travel is holdings in Sydney Airport and Webjet. Sydney Airport is one of the highest quality pieces of infrastructure in the country with a long concession life. Indeed, we often describe Sydney Airport as 'critical infrastructure.' We were not surprised a consortium of pension funds made an offer to acquire the company. We expect the long-term value of the scarce assets, and the growing need for pension funds to match their liabilities with income producing assets, will be reflected in support for prices that overrides the detrimental impact of COVID-19 related restrictions on international travel.

In the case of Webjet, its recovery is tied primarily to the reopening of travel markets in European, Asia and North America through its WebBeds business.

Its online travel agency businesses, webjet.com.au and onlinerepublic.co.nz, are largely exposure to domestic rather than international travel. Therefore, any delays to the reopening of international travel to and from Australia will have limited impact on the company.

IDP Education (ASX:IEL)

IDP Education is an extremely high-quality company operating in the up-steam segments of the higher education industry.

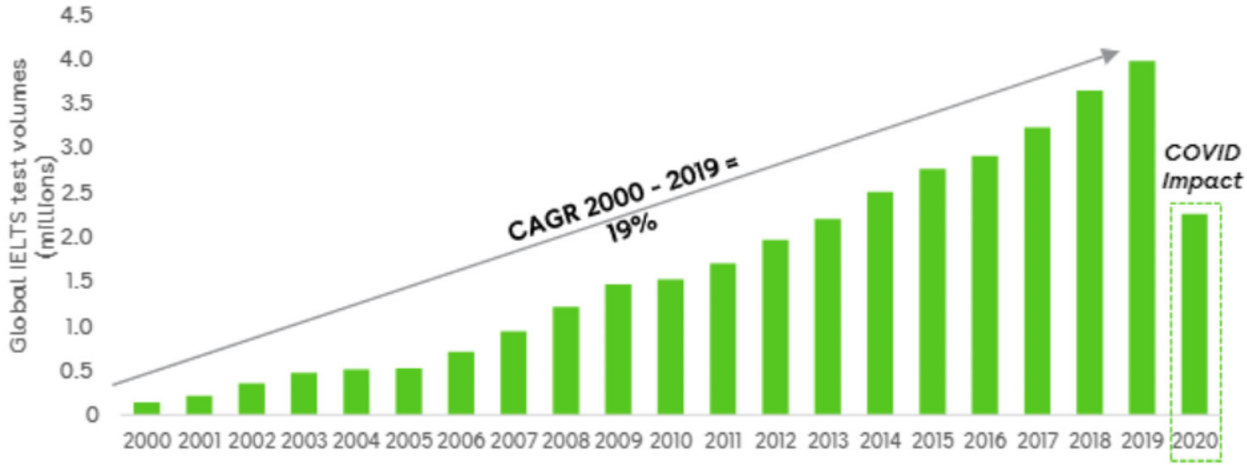
IDP is one of three joint venture partners (IDP, British Council, Cambridge University) that own the International English Language Testing System (IELTS). IELTS is the leading English language competency test in the world, with four million taken annually. An English language competency test is a pre-requisite for individuals seeking a migrant or study visa in countries including Australia, New Zealand, the US, the UK and Canada.

Under the joint venture, Cambridge University develops and produces the test, while IDP and the British Council both distribute and administer the test globally. IDP and the British Council pay Cambridge University a royalty per test taken.

In terms of jurisdictions, IDP primarily administers tests in Asia (excluding China), the Middle East, parts of Africa, and Canada, with a small number of tests taken in the EU. It competes with the British Council in all of these countries with the exception of Australia. The British Council has exclusive access to China and the UK, with IDP receiving a small royalty on each test administered by the British Council in China.

The globalisation of labour and education, and the rapidly growing middle class in developing countries, including China and India, has seen demand for western education grow rapidly. Rising English language testing to secure visas has risen correspondingly. IELTS volumes grew at a compound annual growth rate of 19 per cent between 2000 and 2019, with tests in IDP's largest market – India – growing 21 per cent a year between 2010 and 2019.

Figure 3: Volume of IELTS tests taken annually



Source: IDP Education

While this is a reasonably consistent marginal cost business with incremental tests requiring only additional test sites and people, little investment is required to grow the business. Consequently, free cash flow is high relative to reported earnings, and reinvestment requirements are low.

Margin improvement is expected over the next few years as the company completes its roll out of computer-based testing, which will speed up the marking process and reduces testing costs.

More recently, IDP announced the acquisition of the British Council's IELTS testing business in India. This will add almost 500,000 tests annually to IDP's business. Under the British Council's ownership, this business generated annual earnings of approximately A$20 million. This equates to around A$40 of gross earnings per test administered. The average revenue per test was A$236 which implies the unit costs were around A$196 per test.

IDP's average cost per test approximated A$160 in 2019, which is 20 per cent lower. Additionally, average unit pricing in India is roughly 20 per cent lower than other countries IDP operates in as a result of competition with the British Council. Clearly, the opportunity from lower costs and higher prices is approximately A$100 per test.

In addition to earnings growth from the India business, growth may be derived from the acquisition of additional territories from the British Council. This represents transformational reinvestment that would create large amounts of shareholder value for IDP and the other IELTS joint venture partners.

The other major business operated by IDP is the Student Placement business. IDP operates agencies in Asia that work with prospective tertiary students looking to study overseas.

Agents work with students to help them to decide which tertiary institution best suits their needs and helps them with all facets of the application process through to commencement. This includes gathering the required qualifications (including English language test scores), student visas, through to organising services the student will need on arrival such as health insurance and accommodation.

IDP has agreements with the major tertiary institutions in Australian and New Zealand, a range of high-quality universities in the UK, Ireland and Canada and some lower tier institutions in the US.

While the COVID-19 pandemic has severely impacted the international student market around the world, it is also accelerating and enhancing the growing competitive advantages IDP has been developing over the last decade.

The closure of international borders last year saw most markets, and most importantly, Australia and New Zealand, close completely to international students. However, IDP was able to pivot toward the UK and Canada which were still accepting students under certain circumstances. This provided the business with the ability to continue to engage with potential students and generate revenue.

Universities have been starved of high fee-paying international students for almost two years. And while they'll be eager to attract returning students, they have historically been poor and inefficient at acquiring students. We expect IDP's services to be in high demand from institutions as they recover from the pandemic.

Both IDP's English language testing and Student Placement businesses enjoy low capital intensity, generate strong cash flows and have very long runways for growth.

Universal Store Holdings (ASX:UNI)

While Universal Store Holdings is a recent addition to the ASX, the company was established in 1999, specialising in the casual youth apparel segment. Beginning life as a bricks and mortar retailer the passage of time has seen Universal become an omni-channel success.

The company competes with General Pants and Glue and its main point of difference is its inventory lead times are significantly shorter. There is an increased unit cost associated with a commitment to shorter lead times but there is an offsetting reduction in inventory and fashion risks.

We believe growth will come from a meaningful increase in store numbers from the current 65 to between 100 and 120. Much of that increase will come from the more populous states of New South Wales and Victoria, where the franchise is currently underrepresented.

Table 3: Stores by State - Universal vs General Pants

	Universal Store	General Pants
NSW	17	23
VIC	13	13
QLD	19	5
SA	2	3
WA	11	6
TAS	0	1
ACT	2	1
NT	1	0
Total	65	52

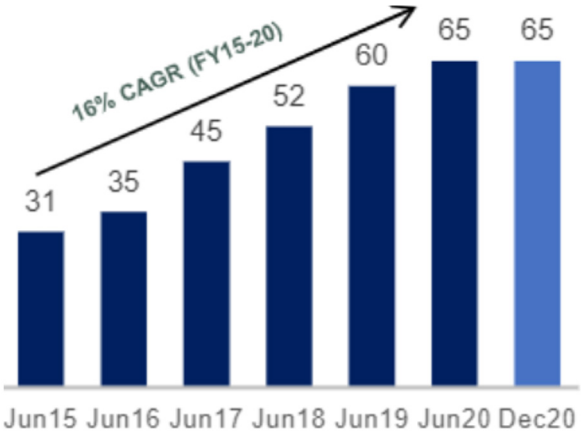
Source: Companies

Moreover, the 100-120 store target excludes potential expansion into New Zealand, which could add another 20-30 stores. Importantly, new stores generate extremely high returns on capital and a pay-back period of approximately 12 months.

Additionally, the existing store base remains relatively immature. Stores ramp up sales over a period of two to three years, and as at the FY21 results, we estimate approximately 20 per cent of existing stores are immature.

Like-for-like sales growth has been well above 10 per cent a year for Universal over the last five years. While growth will inevitably slow in coming years, strong growth rates generate material margin improvement when store cost bases are largely fixed.

Figure 4: UNI – Store numbers at period end



Source: Company

Meanwhile, COVID-19 has accelerated the long-term trend from in-store shopping to online spending, presenting a unique opportunity for fast growing retailers like Universal. The potentially permanent change in consumer habits could, to some extent, adversely impact foot traffic in large format shopping malls. Mall owners will therefore want to attract compelling shopping concepts and on trend retailers. Universal's strong sales and ability to attract consumers puts the company in a strong position to negotiate enticing rental terms, including capped rents, preferred store locations or larger footprints (Universal's preferred store size is 250m2). With a high proportion of store leases coming up for renewal over the next couple of years, management expects to be able to reduce rental costs by over 15 per cent per square metre.

COVID-19 has also resulted in a major boost to Universal's online sales. The brand is currently one of the fastest growing online youth retailers in Australia with higher online conversion rates than competitors. Online sales are expected to more than double in FY21 to represent just under 15 per cent of group sales. The profitability of the company's online channel will be enhanced by the commissioning of a new distribution centre in FY22.

The remaining driver of growth will be increased penetration of private label offerings in the existing stores, and potentially the opening of new store formats dedicated to Universal's own brands. Private label products generate an average gross margin of 68 per cent compared to 56 per cent for third party brands. And private label margins could rise further in the future through direct sourcing.

Outlining the above highlights a plethora of high-return growth levers the company can pull over the next five years and the current share price remains attractive.

Australian Financial Group (ASX:AFG)

One of the themes we see emerging over the next year, as a consequence of low interest rates and asset price inflation driving property activity, is a continued increase in demand for credit. This will see activity increase for mortgage providers, particularly those that are exposed to the flow of credit.

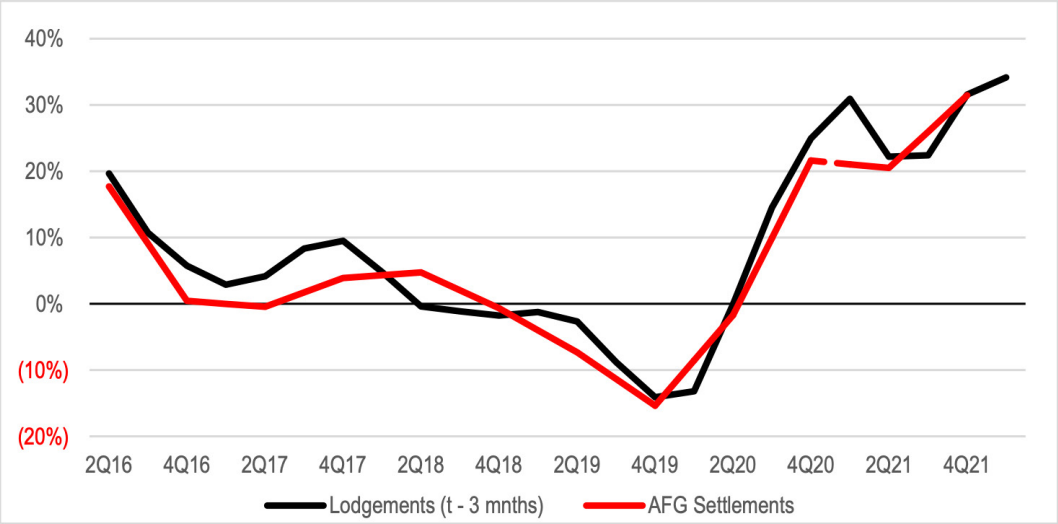
AFG is Australia's second largest mortgage broking aggregator. Aggregators are the connection between mortgage brokers and capital lenders. Being the middleman, AFG receives a brokerage commission (both up front and trailing) from the lenders, passing on just over 90 per cent to the originating broker.

An important distinction is AFG's aggregation business is exposed to the flow of new mortgages settled by lenders, not the growth in the outstanding aggregate amount borrowed.

It's the number of new mortgages taken out rather than the total debt amassed that drives AFG's business.

AFG releases lodgements (mortgage application) data from its aggregator platform every quarter. This data demonstrated a material acceleration in growth in the second half of 2020 as consumer fear regarding the uncertain economic outlook dissipated. Strong growth has continued into 2021.

Figure 5: AFG - Year-on-year growth in the value of mortgage applications lodged



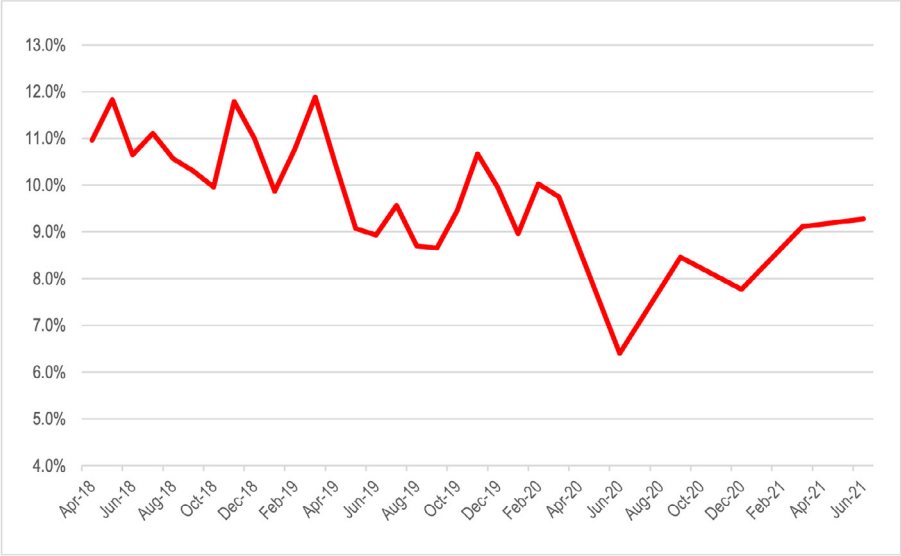
Source: AFG

These figures represent mortgage applications and AFG receives commissions only once the loan is settled. There is a lag of 10 to 12 weeks between lodging an application and it settling. This lag has increased in the last few years due to longer processing times by the banks as a result of the Royal Commission.

Our investment thesis is also constructed around the aggregation business's revenue mix shift relative to 2021. AFG offers its own mortgages to its aligned brokers under the AFG Home Loans (AFGHL) brand. Most of these loans are provided by other lenders (Bendigo, Pepper and NAB) as well as its own non-bank lenders. The loans settled under these brands attract a bonus commission to AFG which it retains. As a result, settlements of AFGHL loans generate a much higher gross profit margin than settlements on third party loans (much as private label does for Universal Stores). Historically, these loans have represented between nine and 10 per cent of AFG's settlements.

Most recent loan application data reveals AFGHL has returned to its traditional share of the overall value of mortgages processed by AFG.

Figure 6: AFGHL Lodgements as a percentage of overall AFG Lodgements



Source: AFG

In the medium to longer-term, aggregation is increasingly about scale and the ability to automate the connection between the lenders and the originating broker. Automation drives down the unit cost of transactions while speeding up processing times.

Scale also allows the aggregator to broaden its panel of lenders, in turn providing aligned brokers with more choice and greater support from lenders, improving their experience.

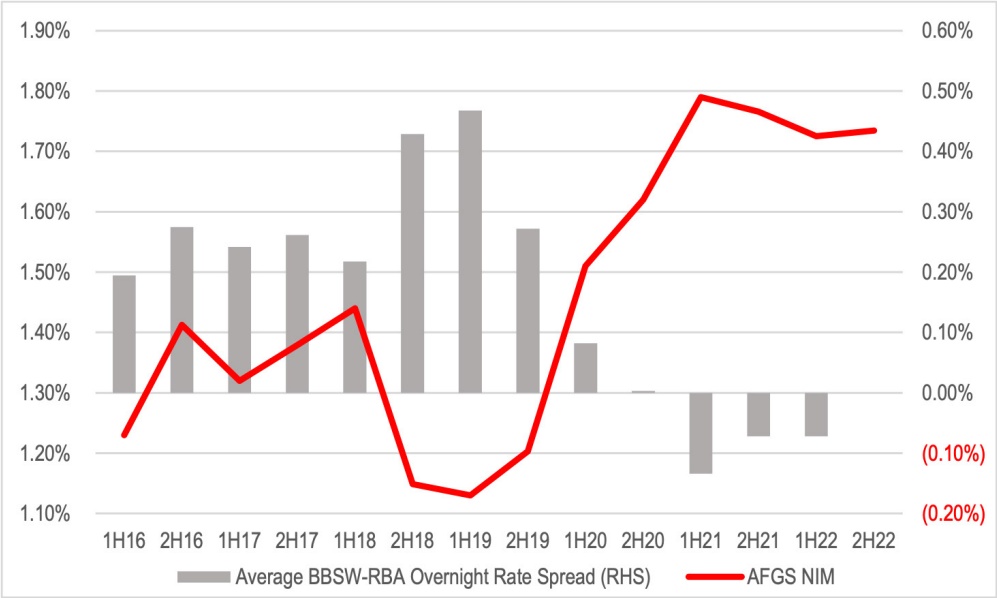
In terms of market share, AFG has the scale to invest in its technology, while also providing strong lender relationships to its partner brokers. Scale enhancements and cost synergies should be the outcome if the 2019 announced merger with Connective proceeds. AFG's market share would double to circa 40 per cent and the ACCC approved the transaction in June 2020. A final hurdle however is court approval, as required by the implementation deed, which the companies are still awaiting. Despite the hearing in the Victorian Supreme Court concluding in March 2020, the decision by the trial judge has not yet been delivered.

Meanwhile, AFG has experienced its strongest-ever growth in broker numbers and settlements since the merger was announced, settling nearly $20 billion in the June 2021 quarter alone.

Until June 2021, the banks have been able to reduce term deposit rates and draw down on the Government's emergency Term Funding Facility (TFF) at 0.1 per cent fixed for three years to reduce their average cost of funding. But the TFF ceased at the end of June.

Additionally, banks are required to hold a certain percentage of their loans outstanding as low risk liquid assets and this puts downward pressure on the average return the banks generate on their interest-earning assets (loan book plus liquids portfolio). Consequently, non-bank or securitised lenders are becoming a lot more cost competitive and wholesale funding costs have fallen dramatically.

Figure 7: Six-monthly average BBSW – OIS Spread vs AFGS net interest margin



Source: AFG

More recently, the excess liquidity in the system has also seen a material reduction in the interest rate spreads paid on RMBS issuance. While this only funds a quarter of the outstanding loan book, if current RMBS spreads are maintained, the average funding cost for AFGS will continue to fall over the coming year as the company issues more securities.

These factors provide material tailwinds to AFG's businesses in terms of both volume growth and margins over the coming 24 months (Figure 7.), and is something we believe the market has not priced into AFG's shares.

Themes for 2022

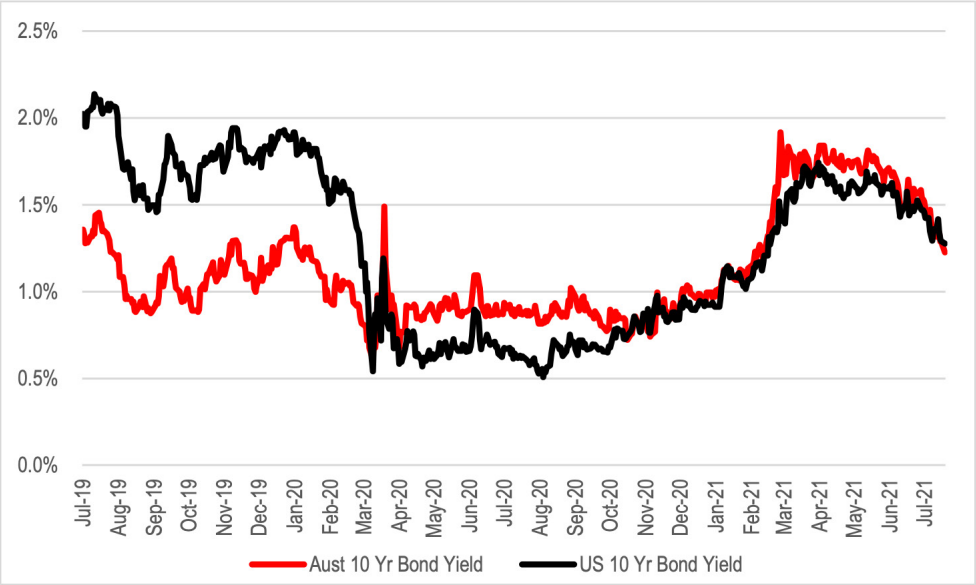
Inflation: Transitory increase or more sustained

The threat of increasing inflation and bond yields was a major concern between February and May 2021.

The COVID pandemic and the subsequent stimulatory response by governments and central banks has produced supply chain bottlenecks for many industries. Ensuing price increases have been experienced across products and services from microchips and lumber to shipping/freight and motor vehicles.

Consequently, the ten-year bond yields in both the US and Australia increased around 75 basis points to around 1.75 per cent. And while sub-two per cent bond yields are still extremely low historically, the pace of the spike in yields worried investors, particularly those holding long-duration growth stocks.

Figure 8: 10 Year Bond Yields

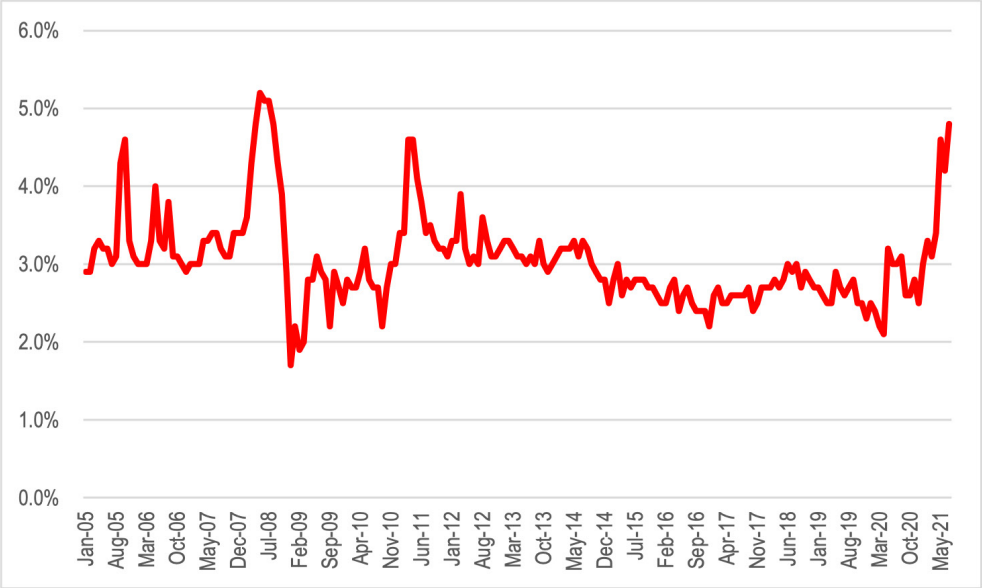


Source: Bloomberg

Central Banks around the world maintained their rhetoric regarding their policy intentions with rates expected to remain extremely low, and liquidity accommodative, due to the belief that inflation pressures would prove transient.

In June and July bond yields surprised many by falling amid higher rates of inflation emerging in economic data. Indeed, the dislocation between buoyant equity markets, the emerging inflation numbers, and these low bond yields is surprising to many.

Figure 9: University of Michigan US inflation expectations over the next 12 months



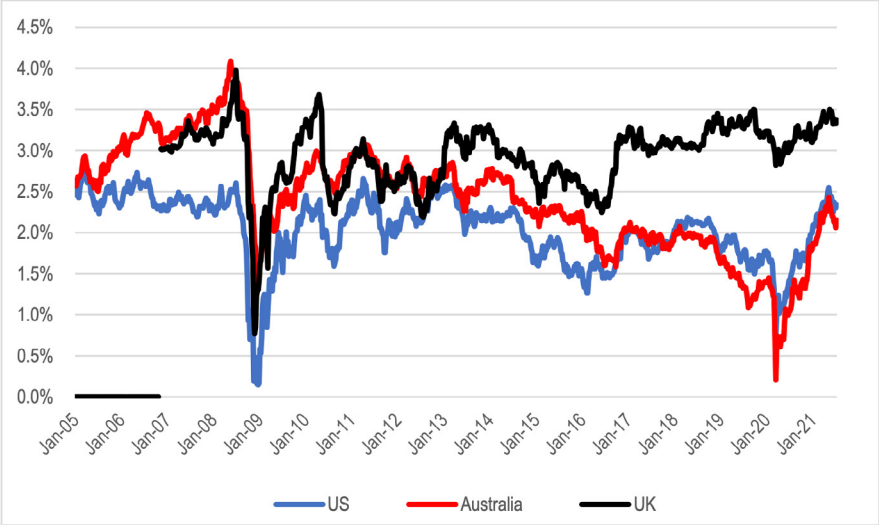
Source: University of Michigan

To understand inflation expectations financial markets are currently pricing-in, and how they've changed, we can examine the relationship between nominal and inflation linked bond yields.

As we have discussed in previous annual letters, the 10-year bond yield can be broken down into two components, the real yield plus inflation expectations over the life of the bond. If the traded yield of inflation linked bonds (bonds that have their value adjusted for price inflation) represents a good proxy for the market's real yield on a 10-year bond, then the nominal bond yield minus the inflation linked yield becomes a proxy for the market's expectations for price inflation over the next 10 years.

Figure 10. looks at this calculation for 10-year bonds in the US, Australia and the UK since 2005.

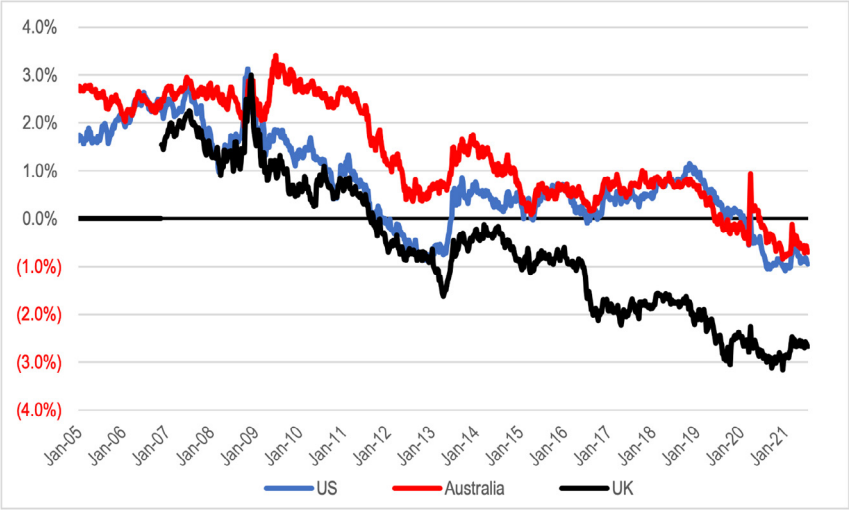
Figure 10: 10-year inflation expectations (10yr bond yields – 10yr inflation linked bond yields)



Source: Bloomberg

It appears the recent fall in nominal bond yields is due more to a fall in real bond yields than inflation expectations, as Figure 11 demonstrates.

Figure 11: Inflation adjusted 10-year bond yields



Source: Bloomberg

An issue for investor returns will be how markets pivot from the current 'Goldilocks' combination of ultra-low interest rates and strong growth, to assumed interest rate rises in 2022 or 2023.

Central banks appear to be moving to tapering their unprecedented stimulus. As the stimulus is withdrawn, climbing real interest rates could be the result. This raises the risk of hiccoughs in markets that have come to accept excessive monetary liquidity as part of the 'lower for longer' narrative.

Wages Growth is Key

Globalisation and technology have resulted in unskilled lower-wage labour in developing countries, competing with unskilled labour in developing countries. Initially this trend was experienced in manufacturing but it has recently extended to white collar roles. Witness for example, the 'offshoring' of call centres, data management and accounting roles.

COVID-19 has a couple of really interesting potential consequences for this long-term structural trend. The first is in the area of unskilled wages. The constraints on freight capacity impacts the ability of domestic companies to supply their customers from developing countries. The consequent higher prices incentivise a return of at least some capacity domestically. We are witnessing this in the medical supplies industry. We expect other industries will report similar experiences.

Additionally, travel and migration restrictions are impacting labour supply. This is important for Australia, the UK and the US, where like many other developed countries, unskilled labour is imported to often perform lower cost work. In Australia much of this work is performed in hospitality and agriculture but as labour supply constraints persist, the impact will be felt in a wide range of industries including construction and mining.

One possible outcome of sustained COVID-19 restrictions is a negative impact on the supply of labour and an acceleration in wages, for the first time in decades, for unskilled work.

COVID-19 inspired investment in technology, including that permitting employees to 'work from home', has proven it is unnecessary to locate employees in a local office or even in the local city. This realisation opens the door to the utilisation of cheaper remote labour, accelerating a trend already underway.

Most importantly it is wage growth Central Banks are most concerned about.

Indeed, it should be pointed out that more inflation has been registered in the last three months than for many years, and yet markets remain relatively sanguine.

While we cannot predict which way sentiment will shift, we have constructed a portfolio that adopts a cautious approach to investing in 'profitless prosperity' companies – those with share prices reliant on long-dated earnings pay offs. Increasing real interest rates resulting from a tapering of fiscal stimulus and a withdrawal of liquidity support by central banks will adversely impact the market value of the shares of these companies more than it will those with solid current earnings and real earnings growth.

COVID-19 – vaccination and reopening

From the very beginning of this pandemic, vaccination has been proffered as the only way out. Vaccines however do not prevent transmitting the virus. They ameliorate the health consequences and improve recovery times and outcomes. In this context, the world is watching countries currently leading vaccination roll outs including The Netherlands, the US and the UK.

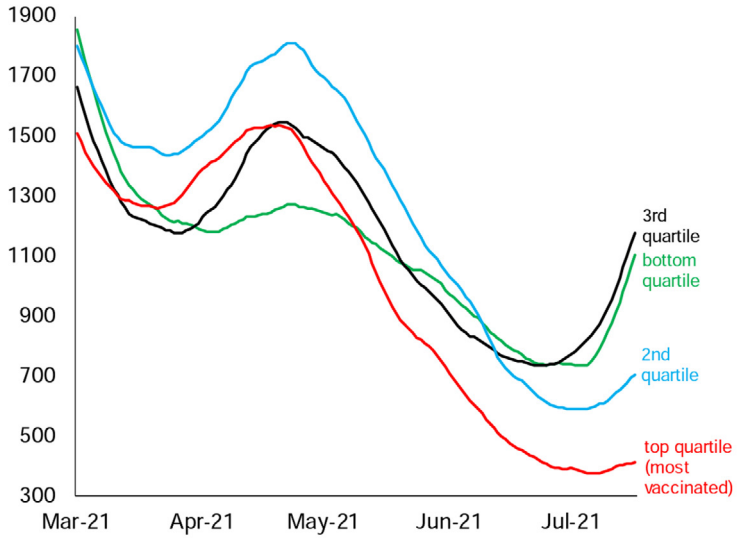
Eradication of COVID-19 might be impossible. The goal of high vaccination rates today is to merely to ensure medical systems can cope with acute cases and minimise deaths. Inevitably, the focus of investors will shift from daily infection rates to hospitalisation rates and declining hospitalisation rates will provide confidence that restrictions can be eased and some semblance of normal activity resuming.

The rapid spread of the more infectious Delta variant however has increased uncertainty regarding the effectiveness of the current suite of vaccines to meet this objective. Mixed data from various jurisdictions paints an unclear and certainly unpredictable path to normal, as many countries do not have high vaccination rates by the time the Delta variant takes off.

For example, Holland's attempt in June 2021 to remove all restrictions surrounding masks, social distancing and travel has failed despite 76 per cent of the population being fully vaccinated.

In the US however, where 80 per cent of over 65s are vaccinated, states with higher rates of vaccination have demonstrated lower transmission, infection and hospitalisation rates, which is encouraging.

Figure 12: US active hospitalisations per million population – States by quartile of population vaccination – 7 day average



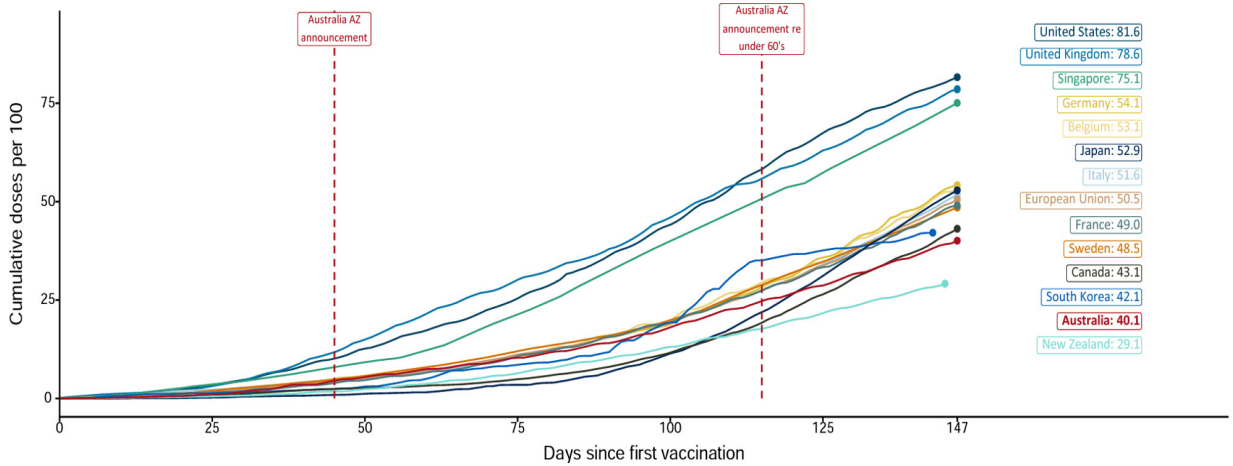
Source: Macquarie

Figure 12. illustrates the increase in hospital admissions is materially higher in states with low vaccination rates. States with the highest rates of vaccination have seen negligible increases. This is an encouraging sign for reopening as it indicates that vaccination rates have a noticeable impact on the hospitalisation rate, even in the face of the spread of the Delta variant.

This brings us to the most significant issue in the medium term for the Australian economy. How do we return to normal?

Clearly, Australia is still a long way from being fully vaccinated, as Figure 13. illustrates. Irrespective of whether high vaccination rates can safely and permanently return populations to normal activity, Australia is several months from the point it can even contemplate experimenting with the idea.

Figure 13: Number of doses per 100 population



Source: Department of Health, Our World in Data

The number of Australians who have received two doses is a much smaller percentage, due to the longer waiting period between AstraZeneca doses. As at 25 July, 16 per cent of the population have received two doses in Australia. This compares to 28 per cent in The Netherlands, 54 per cent in the UK and 49 per cent in the US.

Meanwhile Australia's COVID-19 strategy is being tested by the worst outbreak since September 2020, and by rising resentment towards lockdowns. Despite travel restrictions and border closures, the virus, which found its way into Australia through immigration, has leaked across borders and into regional communities.

Of course, responsibility lies equally with our politicians, the media and the community. The government's slow approach to signing vaccine supply deals, the mixed messaging about the safety of AstraZeneca's vaccine and the population's decision to opt to wait for Pfizer given there were few coronavirus cases in the country anyway, have all lead Australia to its present malaise.

Despite a high vaccination rate likely by early-2022, the Federal Government could face the challenge of convincing a population to return to normal activity.

Concluding thoughts

Eventually, we believe, pressure on state and federal governments will shift from keeping border closed to freeing the population.

Securing 85 million Pfizer doses for delivery in 2022 and 2023 will provide some confidence that restrictions can be eased, provided experiences overseas, by countries well advanced on the vaccination curve, are supportive.

The Montgomery [Private] Fund has balanced its portfolio with the opportunity for reopening and the risk of setbacks in mind.

Late last year we poured cold water on the bearish arguments promulgated by stock market observers and commentators. Valuations were supported by a hitherto unseen combination of unconventional monetary and fiscal support. Meanwhile, evidence of burst bubbles in some individual stocks and market sectors last year remains proof that bubbles can ferment and collapse without disrupting the entire market, provided those assets are not held on the balance sheets of Systemically Important Financial Institutions (SIFIs). The whole market is not a bubble if SIFIs do not hold the assets subject to irrational exuberance.

In summary, and notwithstanding the ever-present risk of setbacks, 2022 has the potential to be a great year for equities.

Ahead of the most recent lockdowns, Australia's economic activity returned sharply to pre-COVID-19 levels, unemployment rates declined abruptly, and labour markets improved with the conclusion of JobKeeper forcing many individuals back to work to earn an income.

Over in the United States – the world's largest economy – the pace of economic recovery continues to surprise upwards, and the central bank's balance sheet could continue expanding into next year. Meanwhile, many companies are already reporting their best-ever outlooks, as well as sequential revenue acceleration over recent months.

All this growth could, of course, produce an inflation surprise in the coming months. And while that could cause some ructions in the market, it is vital to remember that Central Banks have repeatedly explained their willingness to look through interim inflation figures, believing them to be transitory.

Two decades of low inflation suggests a structural change, and that's before we consider currently high household savings.

As Australia's Treasury noted way back in 2011, "By reducing aggregate demand, higher rates of saving and lower household spending may also reduce pressure on prices and wages and therefore interest rates, while more moderate rates of gearing will reduce households' exposure to negative economic shocks."

It seems unlikely we will see a rapid re-emergence of permanently higher rates of inflation. That suggests interest rates will indeed remain low for some time, at least until we see much lower levels of unemployment and perhaps stronger wages growth.

We believe value and growth remain available and in plain sight and a residual question therefore is where can preferred opportunities be found?

There are several themes with investment merit.

Cloud Computing, is a game-changer for business. In the past only the most prominent companies could afford a dedicated in-house IT department and data storage. The advent of third-party data centres changes the competitive landscape allowing smaller businesses to access enterprise-level technology at a fraction of previously prohibitive prices. Consequently, cloud permits digital transformation while enabling disruption by a multitude of companies for which IT was once a barrier to entry. And according to some estimates, penetration of enterprise-level cloud adoption is about 25 per cent. That is where smartphone penetration was 12 years ago and where laptop penetration was nearly 20 years ago.

Another area of opportunity is income. The search for yield remains heightened and global. Members of pension funds worldwide are struggling on income rates of less than one per cent so the demand from their pension funds for assets that produce reliable, if not dull, income streams is acute.

Witness, for example Telstra's desire to split off its mobile towers to permit a 'fairer' reflection of their value. Also, note the New South Wales government's contemplation of a sale of its gambling tax revenue streams.

Additional prospects are offered by the roll out globally of a vaccine. While many investors seek to take advantage of first-order beneficiaries such as travel companies and education providers, the second and third-order consequences will be companies taking market share from slower or less nimble operators and consolidation in some sectors with mergers and acquisitions taking advantage of apparent synergies.

We bundle the final themes under the heading 'Stimulus'. Companies that benefit from government support programs such as, for example, the newly extended HomeBuilder grants scheme are obvious candidates here. Less obvious perhaps is that when the COVID-19 pandemic is over, the world will have the luxury of focusing on other concerns such as climate change. Electric vehicles, clean energy, and decarbonisation will take a more prominent role in the headlines than they already are. Australia, of course, is rich in all the minerals required for the manufacture of lithium batteries, including lithium itself, and the ASX is rich with listed suppliers of the metals required to fuel the next transport revolution.

Australian investors may have many reasons to be very optimistic. Investing in a combination of high-quality defensive growth companies, quality structural growth companies and those quality companies with prospects independent of economic and COVID-19 machinations, is, we believe, the key to ensuring we continue the outperformance that has been demonstrated over the last two years.

We appreciate the opportunity to work for you and we look forward to continuing our investment partnership with you through FY22 and the years that follow.

Sincerely,

Stuart Jackson

Portfolio Manager

The Montgomery [Private] Fund

Roger Montgomery

Chairman and Chief Investment Officer

Montogmery Investment Management Pty Ltd

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