THE MONTGOMERY FUND

2023 Annual Letter to Investors



MONTGOMERY

To our Investors:

AUGUST 2023

Dear investors,

Welcome to the 2023 financial year end update for The Montgomery Fund (The Fund).

Over the past year, The Fund has undergone significant changes. Last September 2022, the investment team from Australian Eagle Asset Management, led by Sean Sequeira, Chief Investment Officer and Alan Kwan, Senior Portfolio Manager, were appointed to manage The Fund. They work alongside the Montgomery team at our offices in the Sydney CBD. After a solid start, we want to assure you that both teams are working hard to maximise the returns of The Fund and support the interests of investors.

Importantly, the Fund's objective has not changed. The Fund continues to focus on providing long-term capital growth for investors by investing in a concentrated portfolio of 25 to 35 high-quality Australian companies and holding them for the long term to let their comparative advantages manifest into superior earnings growth rates.

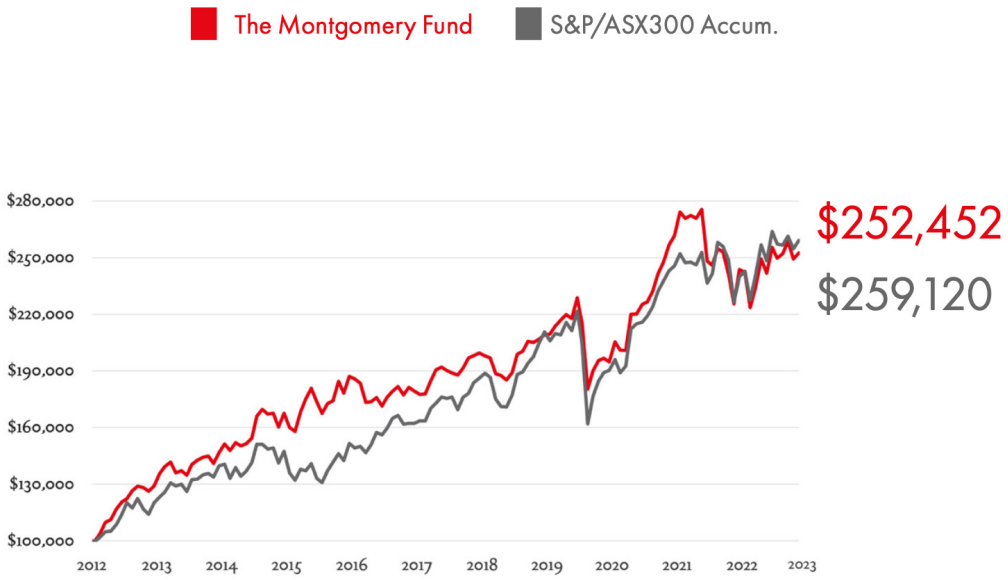
One key improvement to the investment process is the new emphasis on "change". This is extremely important as "change" is generally the catalyst that closes the gap between the share price and valuation of companies. Cheap companies tend to remain cheap until something "changes".

As fundamental bottom-up stock pickers, the Australian Eagle Asset Management investment team assess every major information point for every stock in their investment universe through this lens of "change". The 18-year track record of Australian Eagle Asset Management's investment philosophy and process ensures that the team continually develops their understanding of what has changed in these stocks, enabling them to better understand the future implications of any current change.

The Montgomery Fund performance

The Fund returned 11.92 per cent after fees for the 2023 financial year, compared to the Fund's benchmark – the S&P/ASX 300 Accumulation Index which returned 14.10 per cent. We remain confident that the current investment process will return The Fund to outperforming the benchmark.

The Montgomery Fund performance since inception to 30 June 2023



Source: Fundhost / Montgomery

The Montgomery Fund annual performance information

Period	The Montgomery Fund	S&P/ASX 300 Accum. Index	Relative Performance
2013*	+26.3%	+14.1%	+12.2%
2014	+11.6%	+17.3%	-5.7%
2015	+13.7%	+5.6%	+8.1%
2016	+11.2%	+0.9%	+10.3%
2017	+1.7%	+13.8%	-12.1%
2018	+9.3%	+13.2%	-3.9%
2019	+4.4%	+11.4%	-7.0%
2020	-4.9%	-7.6%	+2.7%
2021	+30.5%	+28.5%	+2.0%
2022	-12.1%	-6.8%	-5.3%
2023	+11.9%	+14.4%	-2.5%
Since Inception	**+8.9%****	**+9.2%****	**-0.3%****

*2013 is the period 17 August 2012 to 30 June 2013, **Compound Annual Returns

Distributions

The Fund paid a distribution of 4.4834 cents per unit, bringing the total distribution to 6.0097 cents per unit for the 12 months to 30 June 2023, and 84.27 cents per unit since the Fund's inception in August 2012. After ending the 2023 financial year with a unit price of $1.4259, we are commencing the 2024 financial year with a unit price of $1.38111.

Distribution History for The Montgomery Fund to 30 June 2023

Year to June	Distribution (cents per unit)
2013*	7.2834
2014	4.0489
2015	13.0725
2016	7.7190
2017	2.1137
2018	12.8559
2019	8.5643
2020	1.6831
2021	5.4930
2022	15.4240
2023	6.0097
Total	**84.2676**

Market overview

The past 12 months have been marked by volatility in equity markets, driven by several major events that added to this uncertainty. The ongoing Russia-Ukraine conflict continued to disrupt global supply chains, and China reopened its borders just before Christmas 2022 to reignite economic growth only to result in a tepid recovery. In addition, central banks faced the challenges of high inflation and low unemployment, leading to the fastest pace of interest rate hikes in history.

The U.S. Federal Reserve responded by raising interest rates from virtually zero in May 2022 to between 5.00 and 5.25 per cent in June 2023. The yield curve for U.S. Treasuries started the financial year flat but became increasingly inverted throughout, while shifting higher with every ensuing statistic or statement which pointed to additional rate hikes. While an inverted yield curve has historically preceded a recession, it's worth noting that not every inverted yield curve has predicted a recession.

The Reserve Bank of Australia (RBA) followed the lead of the U.S. Federal Reserve, also raising interest rates from 0.1 per cent to 4.1 per cent over 13 months. However, like the U.S., uncertainty surrounded the pace and endpoint of interest rate hikes in Australia.

As the interest rate hiking cycle gathered pace in the first half of the financial year, the market favoured value-type stocks that tend to benefit from higher inflation or interest rates.

In stark contrast, in the second half of the year there was a shift, and the market favoured stocks that were previously overlooked, namely the higher growth companies with longer dated earnings. Artificial Intelligence (A.I.) became the new favourite theme in the latter stages of the financial year, giving technology stocks an additional boost wherever the market perceived a company's A.I. capabilities to be promising.

Investment strategy

Risk is a nuanced and sometimes misunderstood term. As active fund managers, our primary role is to manage risk and ideally expose the portfolio to "asymmetric risk", focusing on stocks which have limited downside and contain larger upside potential. Sean Sequeira, one of the founding members of Australian Eagle Asset Management, has adhered to the same investment philosophy for over 18 years and has coined the term "recycling of risk". This is where the team methodically examine the downside risk and upside potential of every investment in the Fund's portfolio. Factors such as the length of time in the portfolio, the size of the investment's position as well as exposure to company, industry and macroeconomic risks are all considered. When making portfolio changes, two equally important decisions are taken into account – what is being sold and what is being bought to replace the position in the portfolio. If a position is coming towards the end of its useful life in the portfolio, or is facing imminent downside risk, it will be replaced with a relatively lower risk investment.

As mentioned previously, the past 12 months was favourable to two types of stocks at separate times – value and high growth companies. However, investing the portfolio entirely in either one of these 'buckets' would be irresponsible risk management, given the uncertainty the markets experienced throughout the year.

The team at Australian Eagle Asset Management chose to allocate capital to the best quality companies in both categories. The portfolio was titled accordingly when deemed appropriate, based on information received. This approach met with mixed results due to the level of significant volatility experienced, even on a monthly basis.

Portfolio positioning

The largest changes to the portfolio over the year were also some of the best and worst performers for the Fund.

Starting from November 2022, the Fund significantly increased its holding in **Newcrest Mining (ASX:NCM)**, raising it to almost the maximum portfolio weighting. This decision came after the company's management reiterated their goal of increasing their copper production to 135 kilo tonnes in the 2023 financial year. Despite being primarily known as a gold miner, Newcrest's copper production was larger than that produced by OZ Minerals, one of Australia's largest copper miners, which was acquired by BHP during the year for just under $10 billion.

With the mergers and acquisitions (M&A) cycle heating up, Newcrest was subject to multiple takeover bids from Newmont Corporation, one of the world's largest gold miners. The Newcrest Board agreed and recommended an improved all-scrip bid which is expected to be completed before the end of the 2023 calendar year, pending regulatory and shareholder approvals.

Successful stock picking requires conviction in terms of timing and weighting and The Fund was handsomely rewarded by Newcrest Mining. While the team never bases an investment purely on M&A speculation, the takeover bid was a welcome bonus, shortening the timeframe needed to realise Newcrest's true value. The team is now focusing on the decision to either keep or recycle the Fund's investment in Newcrest (if all approvals go through), given that it is an all-scrip bid by Newmont.

Another one of The Fund's largest holdings, **QBE Insurance Group (ASX:QBE)** was a top contributor to the Fund's performance. When Australian Eagle Asset Management took over the management of The Fund, they initiated this position at maximum weight, as the investment thesis for QBE was already quite advanced.

During the COVID-19 pandemic, the insurance premium cycle gathered upwards momentum, rising bond yields pre-empted the interest rate hiking cycle of the U.S. Federal Reserve, both of which provided tailwinds for QBE's profitability.

At the end of the 2023 financial year, these tailwinds still seemed to be gaining momentum. Factors like inflation, higher reinsurance, and long-tailed claims costs continue to push insurance premiums, resulting in consecutive annual increases in high single-digits. Additionally, a strong employment market and stubbornly high inflation pressures has forced the U.S. Central Bank to continue hiking interest rates in a bid to bring inflation back to its target levels.

We remain focused on the ever-changing market conditions, as they may influence our thinking and positioning for QBE, especially in the short-term.

Rio Tinto (ASX:RIO) rounded out the top three contributors to The Fund's performance in the 2023 financial year, benefiting from a buoyant iron ore price that continued to generate strong returns for this increasingly diversified multinational miner.

While the bulk of current earnings come from its low-cost iron ore operations, Rio Tinto has announced a strategic shift towards clean energy minerals, with growing investments in copper and lithium.

Oyu Tolgoi is one of the largest known copper deposits in the world and is 66 per cent owned by Rio Tinto with the Mongolian Government owning the remainder.

The mine's lifespan of at least 50 years, aligns with the expected global copper shortage. The growing global decarbonisation movement forecasts an increased demand for clean energy minerals, essential for electric vehicle production and renewable energy storage.

If Rio Tinto's management can successfully execute their expansion plans, the ongoing societal shift towards decarbonisation should provide additional upside potential that has yet to be factored into the company's share price. Additionally, Rio Tinto's profitable iron ore operations should continue to benefit from growing demand for housing and energy infrastructure. As a result, Rio Tinto was moved to a maximum weight in The Fund's portfolio and remains one of the team's chosen resource exposures at the end of the financial year.

In terms of detractors to performance, The Fund was impacted by a number of unexpected events with the largest detractor being a position in **Elders (ASX:ELD)**, an Australian agribusiness.

The Australian Eagle Asset Management team had held a relatively long-term and profitable position in Elders prior to partnering with Montgomery Investment Management, which started back in 2017. Elder's management had successfully repaired the balance sheet and embarked on a turnaround plan, focusing on becoming a major player in the Australian agricultural industry. The CEO did a remarkable job during these years, and the company continued to grow at a solid rate despite a crippling drought, followed by a devasting flood.

Fast forward to November 2022, and Elders reported a fantastic result for the 2022 financial year, with both revenue and profit growing over 30 per cent, finally benefiting from favourable weather conditions. However, the announcement of the retirement of the long-standing CEO triggered a large sell-off in the stock.

The investment team believed that this sell-off was an overreaction and that the underlying business remained solid, with signs showing the agricultural cycle still holding up. Although the team's assessment about the agricultural conditions was correct, holding onto this position turned out to be the wrong decision. At the May 2023 result, whilst Elders announced a solid revenue growth, profits fell significantly because management seemed to lose control of costs.

The team made the decision to exit The Fund's position in Elders and have learned from this experience, incorporating the lesson into the archives for future reference.

Another large detractor to performance was **Ramsay Health Care (ASX:RHC)**. This position existed in the portfolio prior to Australian Eagle Asset Management taking over. The share price had risen due to a takeover bid by KKR (a large private equity organisation). Unfortunately, KKR withdrew its takeover bid a few days before the handover of the portfolio, resulting in a sharp fall in the share price in the following weeks. As a result, during the transition of the portfolio to Australian Eagle Asset Management, the position in Ramsay Health Care was disposed of at lower levels compared to before the transition.

The third detractor of performance was **ASX Ltd (ASX:ASX)**, which owns and operates the Australian Securities Exchange. The ASX underwent significant changes throughout the past year, but the market seemed to only focus on two main issues – the CHESS replacement project and rising costs. The ageing settlement system, CHESS, was initially to be replaced by a revolutionary blockchain solution by previous management, but multiple delays and cost overruns occurred. When the new CEO was appointed in August 2022, she immediately ordered an independent review of the CHESS replacement project, and in November 2022, announced that the project would not go forward in its current form.

The team's experience with the ASX involved benefiting from rising interest rates on large collateral cash balances. Although the market was warned about rising costs, the team believed that the net interest income would overcome, if not at least match this headwind. This assumption proved to be incorrect as inflation pushed costs to increase to double digits, rising much faster than any benefit from interest rates. As a result, the team has since reduced The Fund's position in the ASX pending further information regarding resolution of these two issues.

In addition to the portfolio changes mentioned above, the Australian Eagle Asset Management team initiated new positions in the following stocks during the year; Xero Ltd (ASX:XRO), a cloud-based accounting software provider; Costa Group (ASX:CGC), one of Australia's largest horticultural companies; Telix Pharmaceuticals Ltd (ASX:TLX), a biotechnology company and Deterra Royalties Ltd (ASX:DRR), a mining company with a focus on iron ore royalties.

A holding in Incitec Pivot Ltd (ASX:IPL), a global manufacturer of fertilisers, was also closed out during the year. The decision to close the position was made when the fertiliser price reached its peak, and the team believed it was time to realise the gains.

For further information about any of these new positions and the rationale for investing in these companies, we encourage you to read the previous monthly reports for The Fund, as well as the blog entries by Sean Sequeira and the Montgomery Investment Management team on www.rogermontgomery.com. These resources provide detailed insights into the analysis and decision-making process behind the addition of Xero Ltd, Costa Group, Telix Pharmaceuticals Ltd, and Deterra Royalties Ltd to The Fund's portfolio.

Outlook

From a broader market perspective, we anticipate continued volatility in the foreseeable future. The U.S. Federal Reserve's reluctance to provide definitive forecasts for their actions has led to ongoing volatility in the bond and equity markets. Until there is a clearer picture on the end of interest rate hikes, this pattern is likely to remain. Despite inflation already peaking, the U.S. Federal Reserve seems to be waiting for further progress towards its 2-3 per cent target range before deciding its next move.

Regarding the portfolio, the investment team are excited as the holdings continue to improve in quality. The newer positions in the portfolio bring a sense of anticipation for the new financial year. With uncertainty still high, these positions align with the previous theme of stocks that perform well in both low and high interest rate conditions.

Xero has a relatively new management team that focuses on balanced growth, setting sensible targets for profitability and cost management. Telix Pharmaceuticals has achieved two consecutive quarters of cash flow positive operations less than a year after launching their first product. Though these two stocks are still relatively small positions, their business momentum supports the investment thesis. The team will continue to carefully monitor these stocks and look to add more portfolio weight, as they make further progress.

While the investment team cannot predict nor guarantee positive future returns, they can assure you that they will diligently apply the same investment philosophy that has led to their 18-year track record of outperformance. The team share a passion for finding and investing in great companies and seeing them succeed over time. This dedication drives the team to wake up every day to try and find the next "Cochlear", which they consider to be a dream company.

Both teams at Australian Eagle Asset Management and Montgomery Investment Management are deeply grateful for your continued support and belief in our investment expertise and process. We thank you for your trust and partnership.





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IMPORTANT INFORMATION

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