MONTGOMERY SMALL COMPANIES FUND

2023 Annual Letter to Investors

MONTGOMERY

To our Investors:

AUGUST 2023

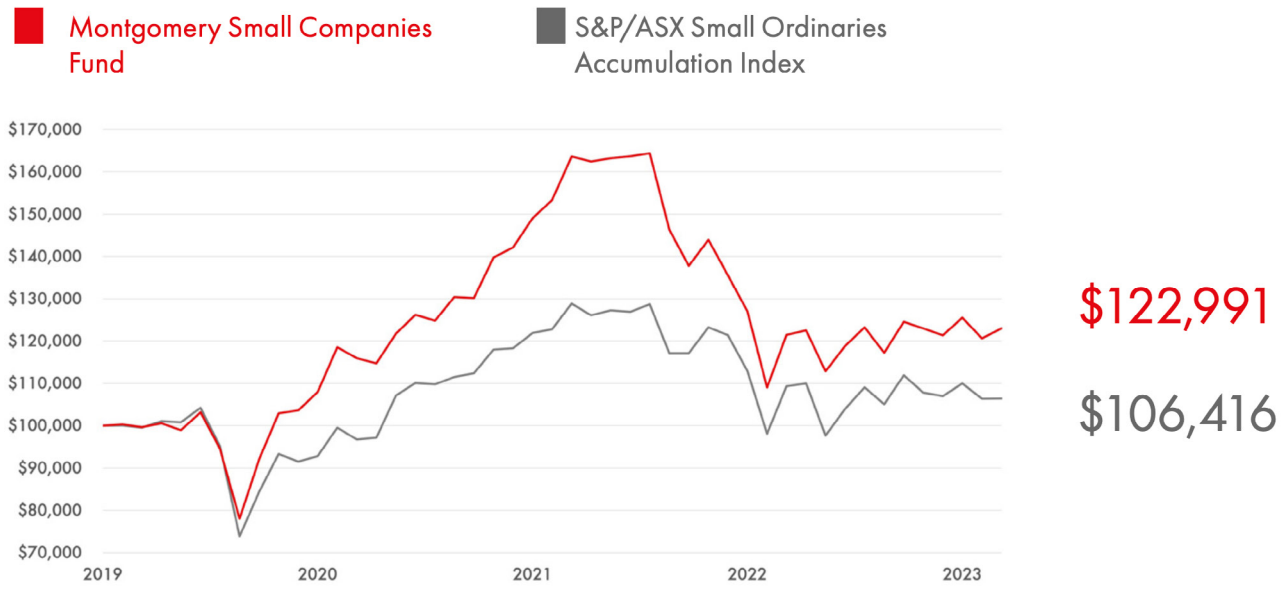
Dear fellow investors,

Welcome to the Montgomery Small Companies Fund 2023 Annual Letter, for the financial year ended 30 June 2023. On behalf of Dominic Rose, Portfolio Manager and myself, we want to express our gratitude for the confidence and support you have placed in us. Just like you, our families' wealth is invested alongside yours. This shared commitment further reinforces our dedication to achieving success for investors in the ever-changing investment landscape.

The Montgomery Small Companies Fund performance

In the year to 30 June 2023, the Montgomery Small Companies Fund (the Fund) returned 12.79 per cent, while its benchmark, the S&P Small Ordinaries Accumulation Index increased by 8.45 per cent. After all fees and expenses, the Fund outperformed the benchmark by 4.34 per cent over the period. Since the Fund's inception on 20 September 2019 to 30 June 2023, the Fund has returned 22.99 per cent, outperforming the benchmark by 16.57 per cent after all fees and expenses.

The Montgomery Small Companies Fund performance since inception to 30 June 2023



Source: Fundhost/ Montgomery

Distributions

With the conclusion of the 2023 financial year, the Fund paid a distribution of 0.7777 cents per unit. Accordingly, after ending the 2023 financial year with a unit price of $1.1354, we commenced the 2024 financial year with a unit price of $1.1276.

Distribution history for the Montgomery Small Companies Fund to 30 June 2023

Year to June	**Distribution (cents per unit)**
2021	7.8912
2022	2.6168
2023	0.7777
Total	**11.2857**

Market overview

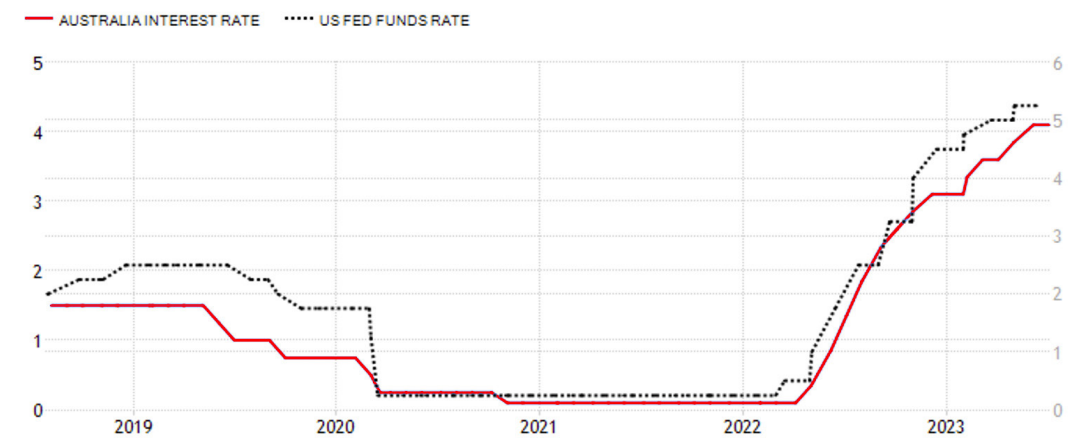
Despite newspaper headlines suggesting an impending recession, equity markets performed solidly throughout the year.

In the U.S., led by a small group of 'Megacaps', the NASDAQ Index increased 25 per cent, the broader S&P 500 gained 12.7 per cent, and the Fund's benchmark, the S&P Small Ordinaries Accumulation index, rose 8.5 per cent.

The bulk of these gains were delivered in the second half of the financial year, as investors adopted a more balanced view on the economic risks at hand. Furthermore, the sentiment towards growth stocks was positively influenced by media headlines indicating that artificial intelligence (AI) tools are ready for mainstream adoption.

Inflation readings, excluding China, have become broad-based and so Central Banks around the world have stuck to the inflation fighting task. The U.S. Federal Reserve's interest rate tightening cycle commenced in March 2022, while Australia followed suit a little later in May 2022. Throughout the 2023 financial year, the U.S. Federal Reserve rates increased by approximately 350 basis points to 5.00-5.25 per cent and the Reserve Bank of Australia (RBA) cash rate rose by 325 basis points to 4.10 per cent, with an additional rate rise in early July 2023. Such a rapid succession of rate increases was a significant undertaking in a relatively short period.

Interest rates in the U.S. and Australia from 2019 to 2023

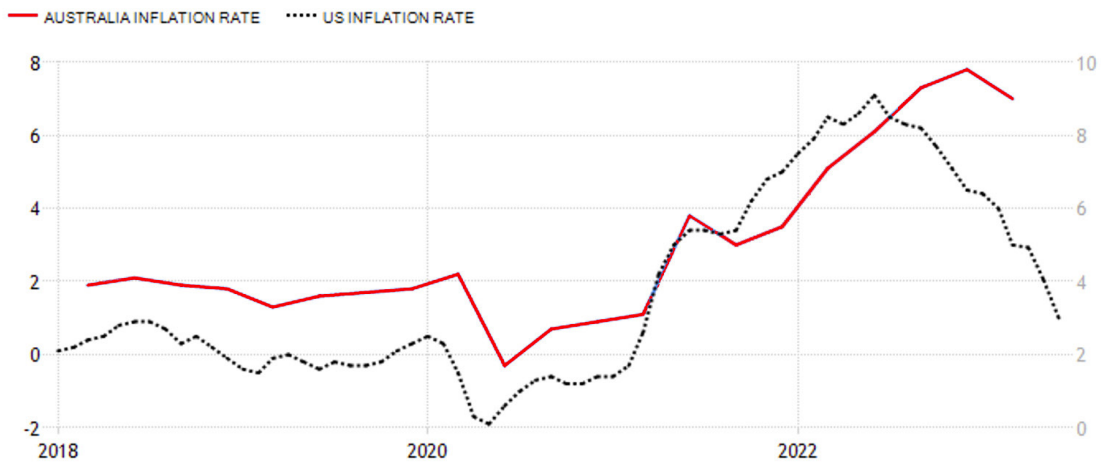


Source: Trading Economics

The latest data indicates that inflation is easing in the U.S. However, in Australia our economic cycle (and rate rises) have so far lagged behind the U.S., and inflation levels remain elevated.

The recent peak in inflation data shows that we might soon reach the apex of interest rates for this particular cycle. Yet, there is concern that rates may need to stay in restrictive territory for some time as labour market and consumer spending data, particularly in Australia, have shown more resilience to rate hikes than expected.

Inflation rates in the U.S. and Australia from 2018 to 2023

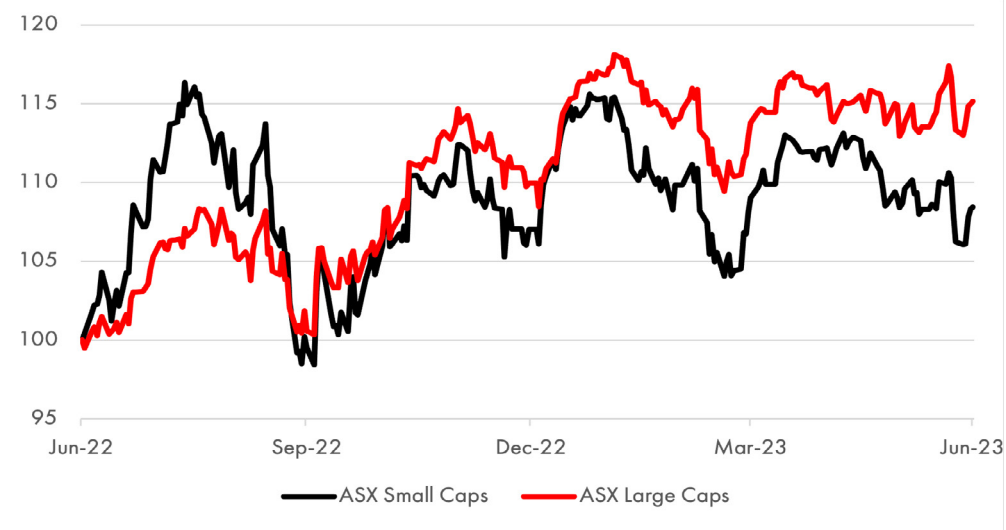


Source: Trading Economics

China's post-COVID reopening has so far disappointed markets. Its domestic consumption alone has not been enough to counterbalance the impacts of weaker demand from its trading partners. Consequently, materials stocks have been volatile throughout the 2023 financial year. However, more recently, investors have been buying in anticipation of stimulus that may be required to lift China's economic performance. Unlike many Western economies which continue to battle high inflation rates, China's inflation remains low. This provides some room for the Central Government to support its economy.

In Australia, the challenges of high-cost-of-living pressures have been further exacerbated by the well-known "mortgage cliff". A record number of mortgages are rolling off cheap fixed rates which were available at very low rates during COVID, to much higher variable rates. This drain on household finances is now beginning to show up in retail sales data. As a result, consumer discretionary stocks have come under selling pressure following multiple profit warnings from retailers across May and June 2023.

FY23 Small caps versus big caps performance – small caps underperformed by 6.7 per cent



As illustrated in the above graph, small cap stocks (as measured by the Australian Small Ordinaries Accumulation Index) returned 8.4 per cent in the 2023 financial year, while large caps (as measured by the S&P ASX 100 Accumulation Index) rose 15.1 per cent. That's the second consecutive year that small companies have under-performed large companies significantly, with a cumulative underperformance of 22.1 per cent. As the chart below shows, one of the biggest factors driving market performance in Australia was company size. Small companies under-performed because they are small. In times of market stress, the performance of small companies can dislocate from their fundamentals as investors prefer larger and more liquid companies over smaller ones. We believe this is what we have seen in markets over the past two years. We think this underperformance presents an interesting opportunity for small companies.

Relative factor returns for the 2023 financial year



Source: Macquarie Equity Research, MSCI, FactSet, July 2023

Investment strategy

The Fund concentrates on investing in small domestic companies and does not rely on significant macroeconomic predictions. When shaping the portfolio, our approach focuses on minimising exposure to geopolitical or macroeconomic risks, instead prioritising 'bottom-up stock' analysis for whatever market conditions we find ourselves in.

However, any view of the future would not be complete without first acknowledging (as we always do) the current macroeconomic climate and the risks and opportunities in markets that we see today.

Outlook

Global stock markets are acutely attuned to the prevailing macroeconomic conditions, with the ongoing battle against inflation being a well-known narrative. The markets have been waiting for evidence of the impact of rising rates to combat inflation on the economy since the U.S. Federal Reserve started raising rates in March 2022.

The 2023 financial year was a period of wide potential outcomes from unknown inflation risks, and so far as we step into the 2024 financial year the evidence shows that markets face a narrower potential range of inflation and economic outcomes.

While the need for additional rate increases remains a possibility, the current restrictive interest rate environment and the lag effects from prior interest rate rises requires close observation. Moreover, the diminishing signs of U.S. inflation argue against implementing too many more interest rate increases. Consequently, equity markets have responded positively to the dissipation of these risks, leading to a solid performance in the second half of the 2023 financial year.

That's not to say there is no uncertainty within the economy. The risk of a recession remains on the table, albeit it's starting to look like the most likely scenario is somewhere between a soft landing (no recession, but a slowdown) and a very mild recession. The extent of any downturn will likely be driven by Central Banks trying to reduce excess demand in their efforts to curb inflation, rather than a structural imbalance in the economy. If they push too hard or for too long, then the mild recession scenario could occur, with the response being to cut rates to repair demand. Insufficient reduction of demand leaves inflation higher, which encourages more rate rises. It is a fine balance, and could go either way, but the extent of the recession outcome looks mild, as evidenced by the strength and resilience of labour markets observed to date.

So, what implications do all of these factors have for earnings and markets? The impact of the economic slowdown driven by inflation is yet to fully materialise on earnings, but here in Australia we won't have long to wait. We have started to see weaker sales in exposed areas of retail like apparel, and we expect the outlook for discretionary retail and consumption to be weak in the 2024 financial year. These areas are likely to experience the demand adjustment the RBA is trying to achieve.

The slowdown is expected to broaden across various sectors, potentially leading to a recession in Australia. The extent and scope of this downturn will depend on how aggressively the RBA needs to adjust interest rates to curb inflation. We expect a slowdown in corporate earnings driven by weakening end demand in consumer facing sectors, and slowing in others, in conjunction with rising costs that will squeeze margins. Of course, some companies will do better than others, and it is our job to identify and invest in those companies where potential for growth and resilience is not already priced by markets.

Portfolio positioning

Our current view is that the recent under-performance of small cap stocks compared to big caps is an opportunity for positive catch-up potential in small caps. This prospect has us excited to find the winners in that scenario and we think this may be found in the most unloved parts of the small cap market, and the two most obvious areas are growth and consumer stocks, both which have underperformed.

The investment case for consumer stocks looks challenged in our view, yes share prices have declined on the fear of a downturn but it's hard to work out just how weak earnings may be in these stocks and for how long. Moreover, the valuation regime upside case depends on a cyclical upswing scenario which may not play out if interest rates need to stay higher for longer. There is a risk that this group of shares feel every bump on a potentially long road. We don't like the risk reward there, yet.

Growth stocks on the other hand look to have an interesting set up. These stocks saw a major shift in investor attitude last year and that drove a material change in their valuation regime. During the post-COVID reflation period investors encouraged growth at any cost, but when inflation reared its head investor attitude pivoted dramatically away from growth towards profits and cashflows, way faster than management teams could effect change.

Nevertheless, the passage of time has allowed many capital-light technology-led growth businesses to adapt and respond effectively. Management teams have made strategic changes, cutting costs and capital expenditures while increasing prices to drive profitability and cashflows. Importantly, they have retained the flexibility to explore future growth opportunities.

Through our rigorous bottom-up stock selection process, we have identified numerous growth stock opportunities that fit this description. As a result, the portfolio is currently overweight growth stocks, reflecting our confidence in their potential to deliver favourable returns in the evolving market landscape.

We remain focused on finding the best risk-reward opportunities in the small cap sector. An example is Alliance Aviation (AQZ:ASX), a stock we've had in the portfolio for some time, and we've been steadily adding more to the position. In our view AQZ is a classic under-appreciated small cap story, it's under-researched, and as a result is a stock where we see earnings expectations as considerably under-cooked versus our outlook for the business.

AQZ is an aviation infrastructure company, its competitive advantage is its business model of buying assets (aircraft) that become available during periods of aviation sector distress at a discount. The COVID period was a significant period of stress, and true to strategy AQZ invested, in a big way. AQZ had 37 operational aircraft pre-COVID, and at current count will have up to 104 from acquisitions made during the downturn. Realistically some of these assets will be used as a spare parts pool, but we estimate that available operational assets will be over 90 aircraft. That's a big uplift. Moreover, the recently acquired assets are newer and offer a much higher intensity of use profile, or more flight hours per aircraft in any given year, than the existing assets. It all adds up to the new asset pool having a capacity (available flight hours) of more than triple the existing business. We are optimistic that the true earnings power of the business will become apparent as the new aircraft are put to work.

We see considerable scope for a multiyear earnings growth story here, in the hands of a capable founder led management team all wrapped up in a low valuation. Using consensus earnings expectations, AQZ trades on less than 4 times FY25 earnings before interest, taxes, depreciation, and amortization (EBITDA), and we think those estimates considerably under-estimate the likely earnings power in the business. We think AQZ is an example of the kind of earnings driven opportunity available at good bang for buck prices in a small cap market that's been subject to a sell-off in the past couple of years. And we know that over time, earnings drive share prices.

Conclusion

As we head into earnings season, we anticipate the likelihood of downward revisions to many companies' earnings expectations. This is likely to stem from higher-than-expected costs and higher demand uncertainty in consumer facing sectors like retail and media. We look forward to earnings season producing unexpected opportunities. We've been adding some of those cheap growth stocks to the portfolio and cash levels are now back to 5 per cent.

Thank you for your time reading our financial year 2023 Annual Letter, we look forward to sharing more content with you in the months, quarters and years ahead. Happy investing and thank you for your continued support.



Gary Rollo

Portfolio Manager

Montgomery Small Companies Fund



Dominic Rose

Portfolio Manager

Montgomery Small Companies Fund

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