THE MONTGOMERY [PRIVATE] FUND

2023 Annual Letter to Investors



MONTGOMERY

To our Investors:

August 2023

Dear Investors,

Welcome to the 2023 Annual Letter for The Montgomery [Private] Fund (The Fund).

Over the past year, The Fund has undergone some 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.

Impressively, they have just topped institutional research and consulting firm Mercer's list of Australian best fund managers over five years.

You can read about the Mercer accolade and win here. And the Australian Financial Reviews article Meet Mercer's top fund manager over five years here.

Sean Sequeira, Alan Kwan and Daniel Chan work at our offices in the Sydney CBD. After a very smooth and event-free start, we want to assure you that the Australian Eagle Asset Management team is working tirelessly and single-mindedly to maximise your returns. That's all that matters and the reason we have partnered with Sean, Alan and Daniel.

Importantly, the Fund's objective hasn't changed either. 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.

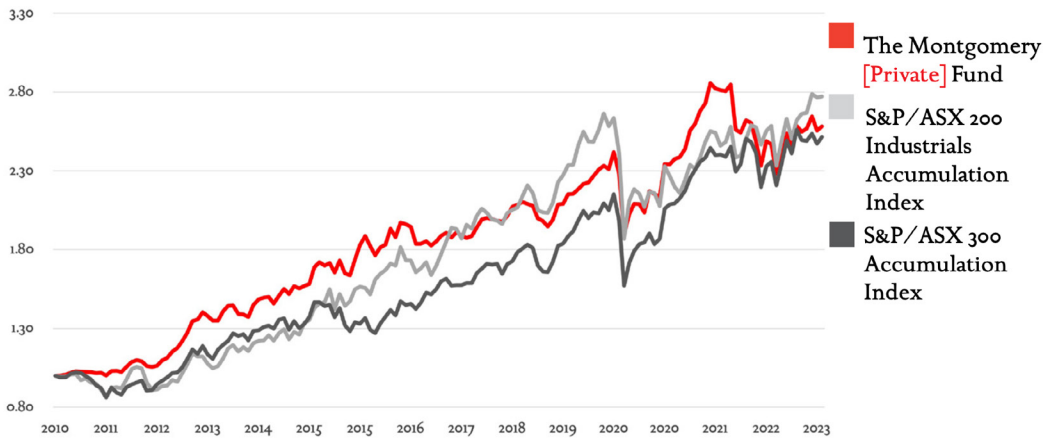
One key improvement to the investment process, and I believe the reason for the team's impressive long-term outperformance is the emphasis on "change" within a business. This is extremely important as the "change" we now look for is the catalyst that should close the gap between price and value. In the absence of change, such as the sale of a loss-making business division or an improvement in the earnings power, cheap companies can remain cheap.

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". Their 18-year track record of consistently implementing their investment philosophy and process ensures the team continually develops and enhances their understanding of what is changing in these companies, and the implications for the shares.

The Montgomery [Private] Fund's performance

The Fund returned 10.70 per cent after fees for the 2023 financial year, while the S&P/ ASX 200 Industrials Accumulation Index – the Fund's benchmark – rose 12.34 per cent. It was during the latter part of the first half of this period that the transition to the new team occurred so the period did not receive the full benefit of the new team's process. The broader S&P/ASX 300 Accumulation Index rose 14.40 per cent. Yes, the underperformance is disappointing, but we now look forward to many more years working with Sean, Alan and Daniel.

The Montgomery [Private] Fund performance since inception to 30 June 2023



Source: Fundhost / Montgomery

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%
2022	-13.0%	-6.8%	-6.2%	3.5%	-16.4%	20.9%	15.2%	11.2%	15.6%	14.0%	15.3%
2023	10.7%	14.4%	-3.7%	12.3%	-1.6%	8.2%	8.2%	11.2%	10.3%	13.3%	12.9%
Since Inception	**7.9%****	**7.7%****	**0.2%****	**8.5%****	**-0.6%****	**28.4%*****	**36.2%**	**40.5%**	**11.8%**	**15.2%**	**16.3%**

*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

The above table reveals the annual returns for The Fund including the materially lower levels of volatility (risk) experienced by investors.

It also reveals that the reason for the currently marginal long-term relative performance against the broad market, as measured by the S&P300 Accumulation Index, is the particularly poor stretch between 2017 and 2019. I have highlighted this period in past letters and do so again in above table. You might recall this period of underperformance was due to holding a very large amount of cash, as we believed at the time the market was expensive. We didn't lose money but underperformed the market, which continued to soar for three years despite being overpriced. Only when the pandemic hit in 2020 did the market finally turn sharply lower.

If we hadn't held as much cash during this period, the relative numbers would today look much better. The reality of course is that we did and so, with the new team, we have emphasised remaining invested in high-quality companies rather than swinging between low and high levels of cash.

Distributions

At the conclusion of the financial year, The Fund paid a distribution of 5.1987 cents per unit (taking the distribution to 100.85 cents per unit since inception in December 2010). Accordingly, after ending FY23 with a unit price of $1.2083, we commence FY24 with a unit price of $1.1563.

Distribution history for The Montgomery [Private] Fund to 30 June 2023

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
2022	9.3135
2023	5.1987
Total	**100.8524**

Market overview

The year began with higher volatility in equity markets, driven by several major events that contributed to the uncertainty. The ongoing Russia-Ukraine conflict continued to disrupt global supply chains, while China's reopening just before Christmas 2022 has proven tepid, failing to reignite economic growth. Additionally, central banks faced the challenges of high inflation and low unemployment, leading to the fastest pace of interest rate hikes in history. By the end of the first half of the 2023 year fears of recession had gripped investors.

Those fears were partly driven by the U.S. Federal Reserve's response to accelerating inflation, 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 commenced the 2023 financial year flat but became increasingly inverted. While an inverted yield curve has historically preceded a recession, it's worth noting that not every inverted yield curve has correctly predicted a recession.

Importantly, a deep recession has not been a part of our base case. In any event, we aren't investing on the back of macroeconomic predictions.

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

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 contrast, the second half of the year saw a shift in sentiment favouring the previously overlooked names among higher-growth companies with longer-dated earnings. Artificial Intelligence (AI) became the theme du jour, giving technology stocks with possible additional AI-related revenue streams an additional boost.

Investment strategy

Risk is a nuanced and sometimes misunderstood term. Our primary role is to manage risk and ideally expose the portfolio to "asymmetric risk", focusing on stocks that have limited downside and in which inhere greater upside potential. Sean Sequeira, one of the founding members of Australian Eagle Asset Management, and now managing the Fund's portfolio with my oversight, has adhered to the same investment philosophy for over 18 years and has coined the term "risk recycling". This is where the team frequently and 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 considered – what is being sold, as well as what is being acquired to replace it. If a position is nearing the end of its useful life, or is facing imminent downside risk, it will be replaced with a relatively lower-risk alternative.

As mentioned previously, the past 12 months were favourable to two types of stocks at different times – 'value' followed by 'high growth' companies. 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 allocated capital to the best-quality companies in both categories. Based on information available, the portfolio was tilted accordingly when deemed appropriate and met with mixed results due to the significant volatility experienced 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.

Commencing November 2022, the Fund significantly increased its holding in **Newcrest Mining (ASX:NCM)**, raising it to almost the maximum portfolio weighting permitted. This decision came after the company's management reiterated their goal of increasing their copper production to 135,000 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 the investment in Newcrest Mining.

We do not base investments on M&A speculation, nevertheless, the takeover bid was a welcome bonus, reducing the timeframe required to realise Newcrest's intrinsic value. The team is now focusing on the choice between keeping or recycling the investment given Newmont has bid for Newcrest with scrip.

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

During the COVID-19 pandemic, the insurance premium cycle gathered upward momentum, while rising bond yields pre-empted the interest rate hiking cycle of the U.S. Federal Reserve. Both produced important tailwinds for QBE's profits.

At the end of the 2023 financial year, these tailwinds were still gaining momentum. Inflation, higher reinsurance, and long-tailed claims costs continue to push insurance premiums up in the high single-digits annually. Additionally, a strong employment market and stubbornly high inflation pressures have forced the U.S. Central Bank to continue hiking interest rates in a bid to bring inflation back to its target levels.

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 most of the company's 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 helpfully with an expected global copper shortage. The growing global decarbonisation movement is driving an increasing frequency of forecasts for increased demand for clean energy minerals essential for electric vehicle production and renewable energy storage.

If Rio Tinto's management can successfully execute its 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.

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 team had held a relatively long-term and profitable position in Elders, established in 2017, prior to partnering with us at Montgomery. 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 performed remarkably during these years, and the company continued to grow at a solid rate despite a crippling drought, and subsequently, a devasting flood.

Fast forward to November 2022, and finally benefiting from favourable weather conditions, Elders reported a fantastic FY22 result, with revenue and profit growing over 30 per cent. The announcement of the retirement of the long-standing CEO however, triggered a large sell-off in the stock.

The investment team concluded this sell-off was an overreaction and that the underlying business remained solid, with evidence the agricultural cycle was holding up. Although the team's assessment of agricultural conditions was correct, holding onto this position turned out to be incorrect. At the May 2023 result, whilst Elders announced 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.In addition to the portfolio changes mentioned above, the team initiated new positions in the following stocks during the year; cloud-based accounting software provider, Xero Ltd (ASX:XRO); one of Australia's largest horticultural companies, Costa Group (ASX:CGC); biotechnology company, Telix Pharmaceuticals Ltd (ASX:TLX); and a mining company with a focus on iron ore royalties, Deterra Royalties Ltd (ASX:DRR).

The Fund exited a holding in Incitec Pivot Ltd (ASX:IPL), a global manufacturer of fertilisers, during the year just after the team assessed fertiliser prices had peaked.

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 our blogs at www.rogermontgomery.com. These resources provide detailed insights into the analysis and decision-making process behind the addition to the portfolio of Xero Ltd, Costa Group, Telix Pharmaceuticals Ltd, and Deterra Royalties Ltd.

Outlook

It is not unreasonable to expect continued volatility, however it is also reasonable to assume steady gains, particularly if the much-hyped recession turns out to be shallower than currently feared by many others.

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 of the end of interest rate hikes, volatility is likely to continue featuring. Despite inflation peaking and core inflation (now at 3.6 per cent) heading towards the Fed's target of 2 per cent, the U.S. Federal Reserve seems to be demanding further progress.

Regarding the portfolio, the investment team are excited by the holdings continuing to improve in terms of quality.

Meanwhile new positions in the portfolio bring with them anticipation for the new financial year. With high uncertainty a feature of current market sentiment, these positions align with previous holdings that perform well in both low and high-interest rate environments.

Xero has a relatively new management team that focuses on balanced growth, setting sensible profitability and cost management targets. Telix Pharmaceuticals has achieved two consecutive cash flow positive quarters of less than a year after launching their first product. These two stocks still command relatively small positions in the Fund but the positions are supported by the underlying business momentum. The team will carefully monitor each business and currently expects to add to each position as management makes further progress.

While we cannot predict nor guarantee future returns, we can assure you we will diligently apply the same investment philosophy that has led to the 18-year track record of outperformance reported by Australian Eagle and the same process that resulted in Mercer crowing them Australia's best fund manager over five years.

Each team member shares a passion for uncovering and investing in great companies and watching them succeed. We're dedicated to finding and owning the next "Cochlear".

We remain dedicated to your service, to producing class-leading returns, to managing your risk, and we are deeply grateful for your continued support and belief in our investment expertise and process. We thank you for your trust and partnership.



Roger Montgomery

Founder and Chairman

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Sean Sequeira

Chief Investment Officer

Australian Eagle Asset Management



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Senior Portfolio Manager

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IMPORTANT INFORMATION

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