

THE MONTGOMERY [PRIVATE] FUND

Annual Letter to Investors

July 2020



MONTGOMERY

To our Investors:

July 2020

Dear Investors,

The S&P/ASX300 Accumulation Index returned a loss of 7.61 per cent for the 2020 financial year, its first loss for eight years. The Fund's benchmark, the S&P/ASX 200 Industrials Accumulation Index, generated an even greater loss of 12.64 per cent for the financial year.

The Montgomery [Private] Fund (The Fund) outperformed both indices, however The Fund delivered a net loss of 4.49 per cent for the financial year to 30 June 2020 after all fees and expenses. This is The Fund's first negative annual return since its inception in 2010. We always view a loss of capital as disappointing.

Distribution

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

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.

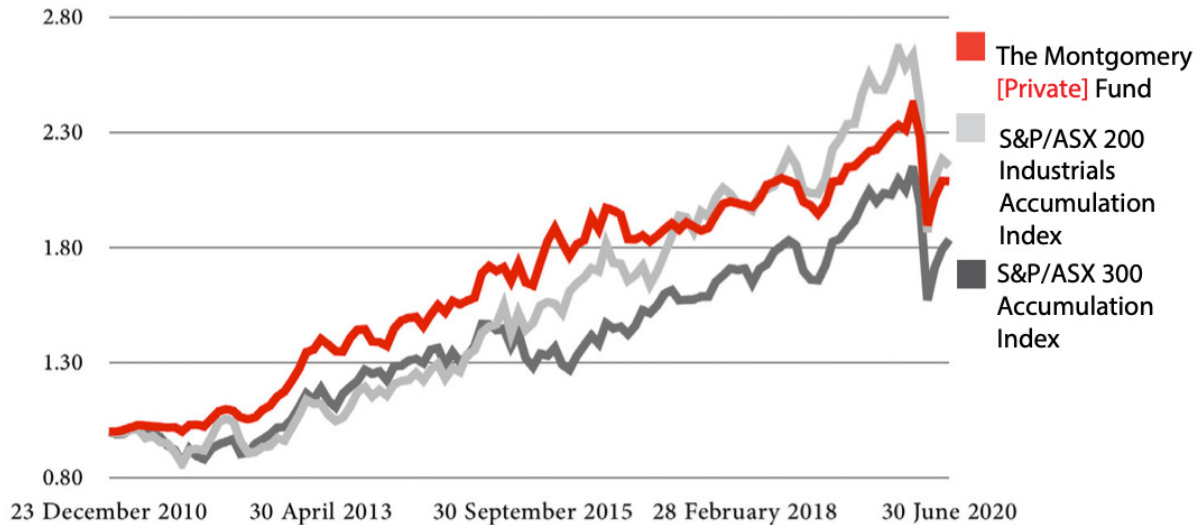
Table 1: Distribution History for The Montgomery [Private] Fund to 30 June 2020

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
Total	80.0545

*23 December 2010 to 30 June 2012

Since inception, distributions have totalled 80.0545 cents per unit, which equates to an annual average 8.4 cents per unit or 8.4 per cent per annum on the \$1 unit price at inception. The distribution at 30 June 2020 was 3.8429 cents per unit, and so after ending FY 2020 with a unit price of \$1.1475, we commence FY 2021 with a unit price of \$1.1091.

Figure 1. The Montgomery [Private] Fund Cumulative Performance



Source: Fundhost

Table 2: Annual Performance Information

Period	Returns					Maximum Drawdown			Annualised Volatility		
	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%
Since Inception	8.0%**	6.6%**	1.5%**	8.4%**	-0.4%**	28.4%***	36.2%	40.5%	11.5%	15.6%	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

Looking back at the 2020 financial year

The Australian equity market delivered its first negative total return in nine years, with the broader market recording a loss of 7.6 per cent including dividends over the twelve-month period as measured by the S&P/ASX 300 Accumulation Index. Most major global equity markets also delivered a negative return for the year. The main exception was the US, where continued gains from the technology ‘megacap’ stocks more than offset the negative returns from the rest of the market.

Indeed, it is worth noting that at the time of writing, the US S&P500 is hovering down a couple of per cent for the year, but this observation masks a material divergence between ‘megacap’ technology stocks and everything else (see Figure 2.). Indeed, in the absence of six technology stocks – Apple, Google, Facebook, Microsoft, Amazon and Nvidia, the US S&P500 would be down 10.6 per cent year-to-date.

In six years, mega-cap US tech stocks have surged five-fold in price...



The 2020 financial year can be broken down into two periods. The first eight months, to the peak of the market on 20 February 2020, followed by the COVID-19 driven sell-off and subsequent recovery. The first period was broadly positive for all indices, while only the tech-heavy NASDAQ was able to eke out a positive total return during the COVID-19 crisis.

Importantly, The Fund outperformed the broad market during the first period despite holding a high level of cash, in anticipation of volatility. The Fund then also outperformed impressively during the COVID-19 inspired panic.

Table 3: FY20 total return of major global indices in Australian dollars

				28-Jun-19	20-Feb-20	30-Jun-20	Total Return to 20-Feb-20 From 20-Feb-20		Total FY20
Americas									
S&P 500 Total Return	USA	SPXT		8,427.1	10,366.5	9,218.7	23.0%	(11.1%)	9.4%
NASDAQ COMP TOTAL RETURN	USA	XCMP		13,342.2	17,329.4	17,234.5	29.9%	(0.5%)	29.2%
Russell 2000 TR Idx	USA	RU20INTR		11,216.5	12,977.7	10,657.3	15.7%	(17.9%)	(5.0%)
S&P/TSX COMPOS TR INDEX	Canada	0000AR		62,298.1	72,702.1	59,631.7	16.7%	(18.0%)	(4.3%)
S&P/BMV Mexico TR	Mexico	INMEXRT		236.9	269.8	180.6	13.9%	(33.1%)	(23.8%)
Europe									
FTSE 100 TR GBP	UK	TUKXG		12,190.6	13,449.0	10,426.4	10.3%	(22.5%)	(14.5%)
CAC 40 GR	France	CACR		24,290.0	26,905.7	22,211.7	10.8%	(17.4%)	(8.6%)
TECDAX PERFORMANCE INDEX	Germany	TDXP		4,659.0	5,323.6	4,819.7	14.3%	(9.5%)	3.5%
FTSE MIB TR	Italy	TFTSEMIB		70,760.9	85,164.4	66,672.4	20.4%	(21.7%)	(5.8%)
IBEX 35 INDEX	Spain	IBEX		14,903.6	16,196.0	11,800.1	8.7%	(27.1%)	(20.8%)
Asia									
Nikkei Total Return Idx	Japan	NKYTR		451.5	513.5	491.9	13.7%	(4.2%)	8.9%
HK HSI Total Return Index	Hong Kong	HSI 1		14,873.0	15,531.0	13,468.7	4.4%	(13.3%)	(9.4%)
SHANGHAI TOTAL VAL INDX	China	SHCOVAL		37.9	82.7	55.0	118.0%	(33.5%)	45.0%
FTSE ST STI USD TR	Singapore	TSTIU		7,656.9	7,714.6	6,144.4	0.8%	(20.4%)	(19.8%)
NIFTY 50 TR	India	NIFTYTR		340.1	356.2	279.1	4.7%	(21.7%)	(17.9%)
KOSPI 200 TR	South Korea	KSP2TR		0.4	0.4	0.4	10.4%	(8.2%)	1.3%
S&P/ASX TR 300 INDEX	Australia	ASA52		69,384.8	76,910.4	64,102.1	10.8%	(16.7%)	(7.6%)
S&P/NZX 50 Index Gross	New Zealand	NZSE50FG		10,048.8	11,550.8	10,708.1	14.9%	(7.3%)	6.6%
Montgomery [Private] Fund				1.2014	1.3638	1.1475	13.5%	(15.9%)	(4.5%)

Source: Bloomberg

The eight months to February

The first eight months of the financial year can best be described as a 'melt up' in equity prices as the perception of 'lower for longer' bond yields became entrenched in the psychology of investors. The market largely ignored broad-based earnings disappointment in the half year reporting season, as well as increasing trade tensions between the US and China.

It appeared nothing would stop the global expansion and rising asset prices. The market viewed any downside risks to be limited as Central Banks had time and again proven that they were ready and willing to cauterize market weakness by releasing massive liquidity.

Retailers generated strong returns during first half of the financial year, while energy stocks benefited from rising oil prices in the December quarter.

The Australian banks commenced the financial year positively following the surprise Federal Election victory by the Coalition in May. However, in the December quarter that positive momentum reversed. Weak credit demand, interest rate spread pressure from falling interest rates, as well as continued customer remediation charges conspired to deliver weak results in late October. Earnings weakness depleted equity capital from bank balance sheets, forcing equity raisings from Westpac and later National Australia Bank. As a result, the major banks returned to the bottom of the share market performance ladder by the end of February and The Fund's significant underweighting to the banks (discussed below) proved prescient.

In January, despite alarming news of a new coronavirus spreading through the Chinese province of Wuhan, markets remained complacent.

Only in the last week of February, when it became clear that efforts to contain the outbreak within Wuhan Province had failed, did markets globally begin collapsing. Fortunately, The Fund had further increased its cash weighting ahead of this sell off.

The COVID-19 months

March recorded a legitimate market panic. It became clear to many others in the market that the lockdown measures required to contain the virus's spread would have dramatic economic consequences. The Australian economy came to a stop.

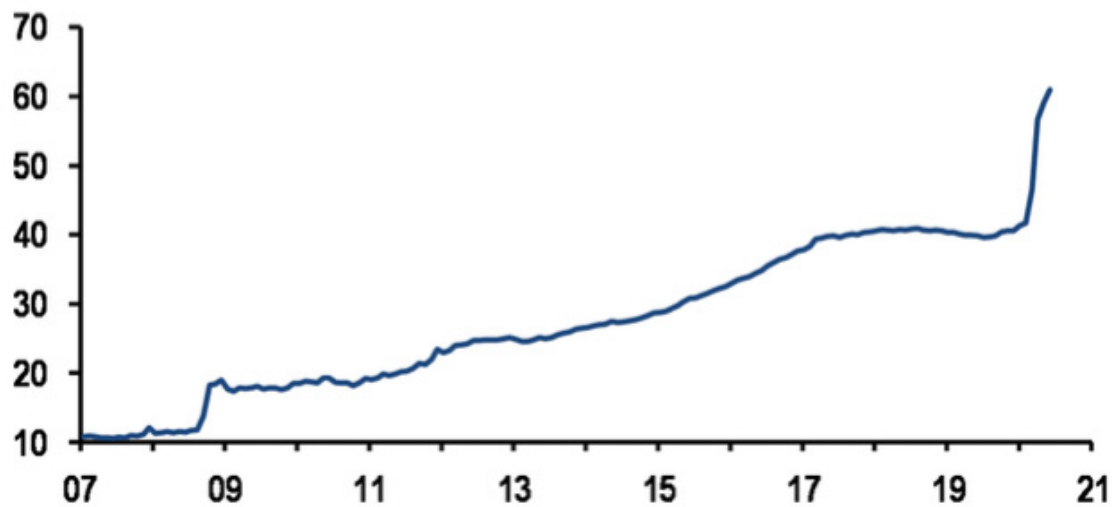
Revenue for some businesses dropped to zero overnight. Companies generally have the ability to adapt, but business models are not designed to accommodate such a sudden halt in activity. The resulting emergency action severely impacted retail, tourism and hospitality and sent shockwaves through the broader value chain, impacting the economy more broadly.

From the peak of the Australian market on 23 February to the lows precisely one month later, the value of the ASX 300 Index had fallen a stunning 36 per cent.

Governments scrambled to announce and implement fiscal measures that, as a percentage of GDP, were the most aggressive ever seen. This was followed progressively by announcements, from the US Federal Reserve and other global Central Banks, materially boosting liquidity in the financial system.

The policy responses culminated on 23 March when the US Federal Reserve (The Fed) announced that it was embarking on a massive Quantitative Easing (QE), which would be far broader than any previously undertaken. The bond buying by The Fed went far beyond the purchase of US Treasuries to include Mortgage Backed Securities, Municipal Debt, and for the first time in The Fed's history, Corporate Debt including junk bonds.

Figure 3: G4 Central bank balance sheet as a percentage of GDP



Source: JPMorgan

This represented an enormous monetisation of debt across the whole US economy, ensuring that credit markets would not seize, as well as effectively protecting companies from bankruptcy.

The consequence of this action is that we are living through a health crisis and an economic crisis but not a financial crisis. This back-stopping of the default risk of the entire economy by The Fed was the catalyst for a rapid market recovery.

By the end of the financial year, the Australian equity market had recouped 54 per cent of the peak-to-trough losses, with some notable winners. Companies facilitating working from home, such as cloud providers and electronics retailers, as well as those supporting the dramatic change in logistics did well. Iron ore companies also performed due to strong commodity prices resulting from ongoing capacity constraints in Brazil, combined with China's reported recovery in economic activity after its initial outbreak in January/February.

The big losers were those in the travel and hospitality value chain, as well as banks, energy and media companies.

Review of The Fund's performance

Earlier in the financial year, The Fund deployed cash to take advantage of a sustained period of low interest rates. Weak wage growth and the resulting continued downward pressure on consumer spending was more likely to see the Reserve Bank reduce rates in the near term.

Anticipating this central bank action would fuel asset price inflation, and demand for income producing assets, The Fund materially increased its exposure to infrastructure assets. Specifically, The Fund increased its investment in both Atlas Arteria and Macquarie Bank, as well as adding Transurban.

Other additions to the portfolio were the fast-growing property fund manager Centuria Capital as well as the leading mortgage broker and securitisation company Australian Finance Group.

This saw The Fund's cash position fall from close to 30 per cent at the start of the financial year to less than 20 per cent by the end of September 2019.

The major banks performed well in the first quarter of the 2020 financial year. Having increased The Fund's exposure to the major banks in June 2019, and following a sharp recovery in prices, the decision was taken to materially reduce exposure in October given the deteriorating risk/return trade off ahead of the release of full year results in late October and early November. This proved prescient with the banks releasing weak results and disappointing capital ratios.

Between July 1, 2019 and the market peak on 20 February, The Fund returned 13.5 per cent, outperforming the benchmark and the broader market by 4.2 per cent and 2.7 per cent, respectively.

Coronavirus

It was clear to the team at Montgomery that dark clouds were gathering well before the 20 February peak in the market. Initially the market took little notice of news reports of a new coronavirus spreading in Wuhan China. Our internal Coronavirus tracking project however indicated transmission rates of the virus were concerning, and importantly, people could become infectious before they were symptomatic. We undertook proprietary analysis of multiple data sources. Our focus including tracking the testing data in major countries, rather than just infection and death rates. If you don't test, you don't find and many countries reporting sanguine conditions were merely reflecting low testing rates.

Low levels of testing provided those countries with a false sense of security, while allowing the virus to continue spreading. Our data collection and analysis revealed alarming deficiencies in the response from many countries, particularly the US.

We identified a material risk of a market sell off, and the decision was made to increase the cash weighting, and reduce The Fund's exposure to companies with direct exposure to supply chain disruption, credit markets or adverse shifts in demand. Consequently, The Fund sold out of IDP Education, AUB Group, Link Group, QMS Media and Ramsay Healthcare, while materially reducing exposure to Aristocrat Leisure, Seek and REA Group.

As the sell-off accelerated, The Fund began taking advantage of more attractive prices by selectively rotating the portfolio into several high-quality businesses.

The main addition to the portfolio in March was Sydney Airport with Reece, Invocare, Scentre Group and Accent also added after the sell off. The Fund also added the Commonwealth Bank of Australia and added to existing positions in Reliance Worldwide, Transurban, REA Group, Atlas Arteria and CSL.

Later in the financial year The Fund increased exposure again to the major banks with lower prices implying aggregate risk-adjusted bad debts of 150 per cent of the losses experienced during the 1990's recession. This was inconsistent with the assumed economic turnaround being factored into share prices elsewhere in the equity market.

Despite reducing our cash weighting, the aggressiveness of the subsequent rally caught us by surprise. The economic consequences of the sudden lockdowns are only just beginning to play out but fiscal policy announcements provided a short-term boost to market sentiment.

Drivers of performance in the 2020 financial year

The strongest contributor to FY2020 performance was metal detection and communications company Codan. The core metal detector business continues to grow strongly as the company broadens its product base. Its entry into the recreational metal detector market through the launch of its Vanquish product late in the calendar year was particularly notable. The company's earnings also benefited from strong results in its communications division.

The leading mobile phone network in New Zealand, Spark New Zealand, also generated good returns for The Fund, performing well during the sell-off due to its defensive characteristics, and also as a beneficiary of increased data usage from stay-at-home and work-from-home demand.

Other notable positive contributors during the year were Link Group, AUB Group, IDP Education and QMS Media, all of which were exited prior to the COVID-19 driven sell-off. In the healthcare industry, CSL and Avita Medical were also solid contributors.

While The Fund maintained a very low exposure to the banks, Westpac was a detractor from performance. Revenue pressure from low interest rates, a materially increased risk of bad debts and the need to raise additional equity capital saw all of the major banks deliver negative total returns of between 16 and 37 per cent for the financial year. The Fund's low exposure to banks greatly reduced the impact on relative performance. In aggregate, the holdings in the major banks contributed a 1.15 per cent loss for The Fund. This compares to a loss of almost six per cent for the broader market.

Looking toward the new financial year

Thematics

1. Yes, activity has recovered, but it remains well below last year and the recovery is now stalling or even reversing.

Panicked market sentiment reversed from late March. The 180 degree reversal was precipitated by massive liquidity support from central banks, combined with a stabilisation in confirmed positive case rates as major economies locked down their populations.

As economies began to reopen, it is not surprising that economic data and other measures of activity bounced back sharply.

The market was encouraged by the bounce in the data, further entrenching the recovery in equity markets.

While the trajectory of recovery appears impressive, what is more important is the absolute level of revenue and earnings that businesses return to post lockdown, and this is likely to remain well below 2019 levels.

As we have repeated innumerable times, the market's definition of 'recovery' is vastly different to that of the real world. The market defines recovery as anything better than rock bottom. Everyone else, however, defines recovery as a return to prior levels of income. A real recovery, one that takes individual and aggregate business incomes back to 2019 levels, is some years away.

The recovery in weekly Australian and US spending data is stalling. Importantly, the impact of massive government fiscal spending at present, not only clouds the picture of underlying conditions but hides what is sustainable by the private sector.

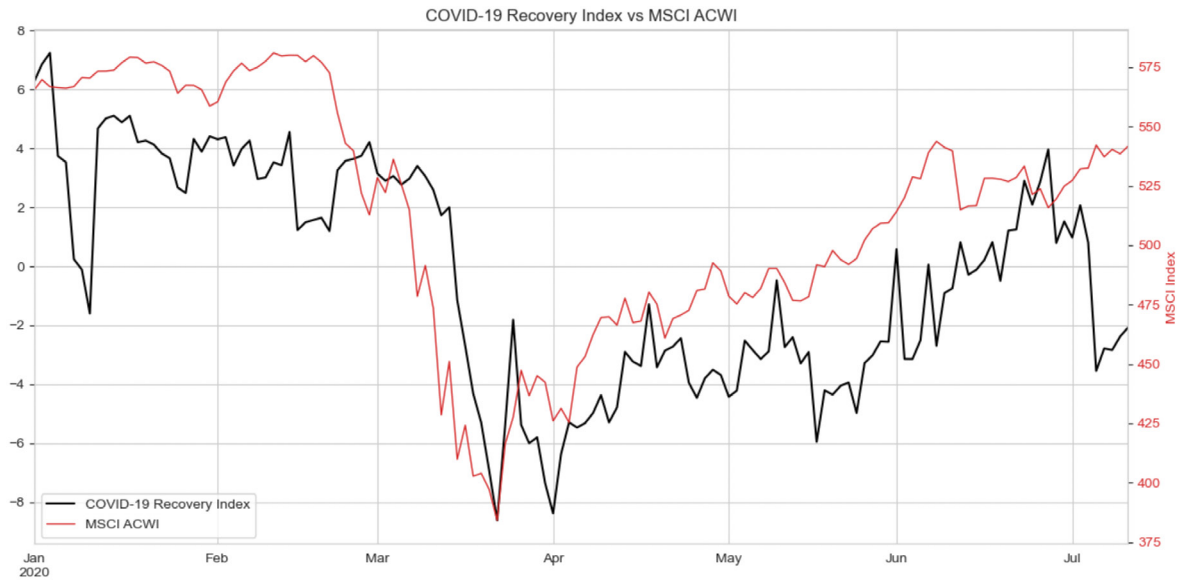
We will not know the true level of sustainable economic activity until fiscal support is wound back. And given rapidly building levels of government debt, one must question the sustainability of the government's largesse.

In Australia, a winding back of fiscal support, including the JobKeeper and JobSeeker programmes, was initially expected to occur in September. But the reintroduction of lockdowns in Melbourne, combined with APRA's four-month extension of waivers on recognition of impaired loans for the banks, means fiscal support measures will be extended beyond September. There is a limit to how long and how broadly these policy supports can remain in place.

As demonstrated in Figure 4., the second wave in the US and Europe, combined with a growing problem in developing market countries like Brazil and India as well as Africa, is already having an impact of activity levels. The JPMorgan Recovery Index measures a combination of COVID-19 case numbers, mobility indices, social activity, behavioural measures, consumption, as well as industrial activity and energy demand.

Figure 4. reveals a material decline in activity in the last few weeks, with activity levels falling back to similar levels seen in April and May. Despite this, global equity markets remain at their recovery highs. And recall the divergence between the MSCI World Index and US Technology shares!

Figure 4: JPMorgan COVID-19 Recovery Index vs the MSCI World Index



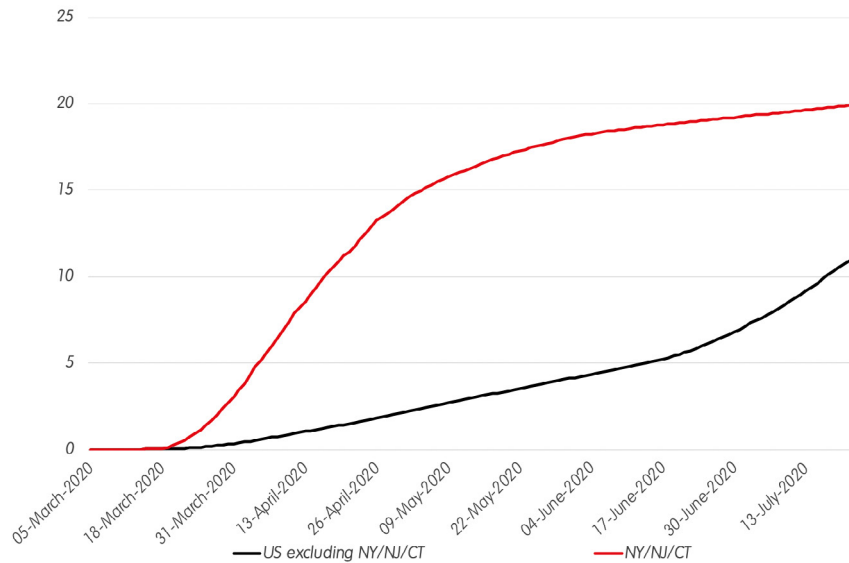
Source: JPMorgan

This suggests to us a growing risk of another correction in equity markets.

2. A second wave of infections is occurring, and lockdowns will be harder to enforce

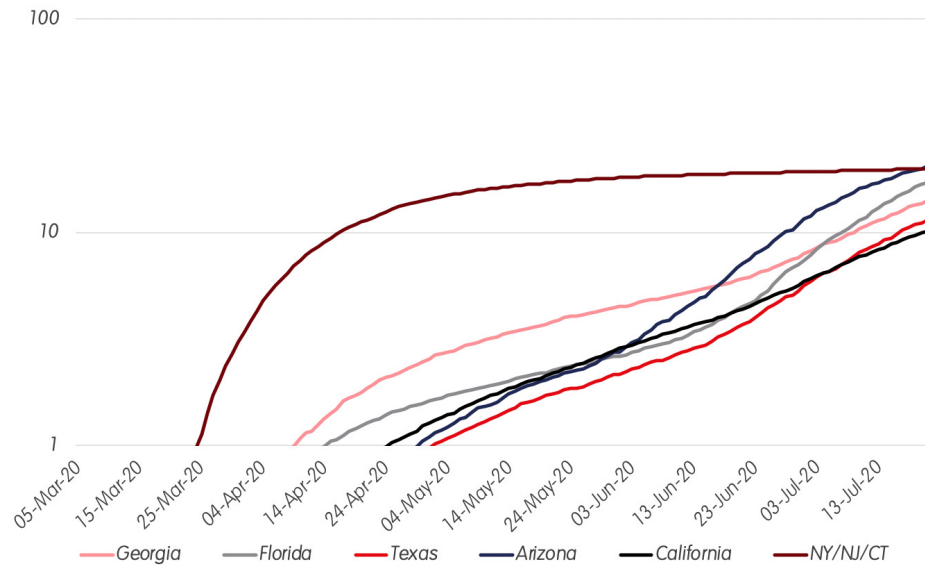
Infection rates are reaccelerating. In the US, the epicentre has shifted from the Tristate area (New York, New Jersey, Connecticut) to southern states that were more reticent to lockdown, and quicker to reopen such as Florida, Texas, Georgia and Arizona.

Figure 5: Total cases per 1,000 residents – NY/NJ/CT vs the rest of the US



Source: Montgomery/CDC and state-based agencies

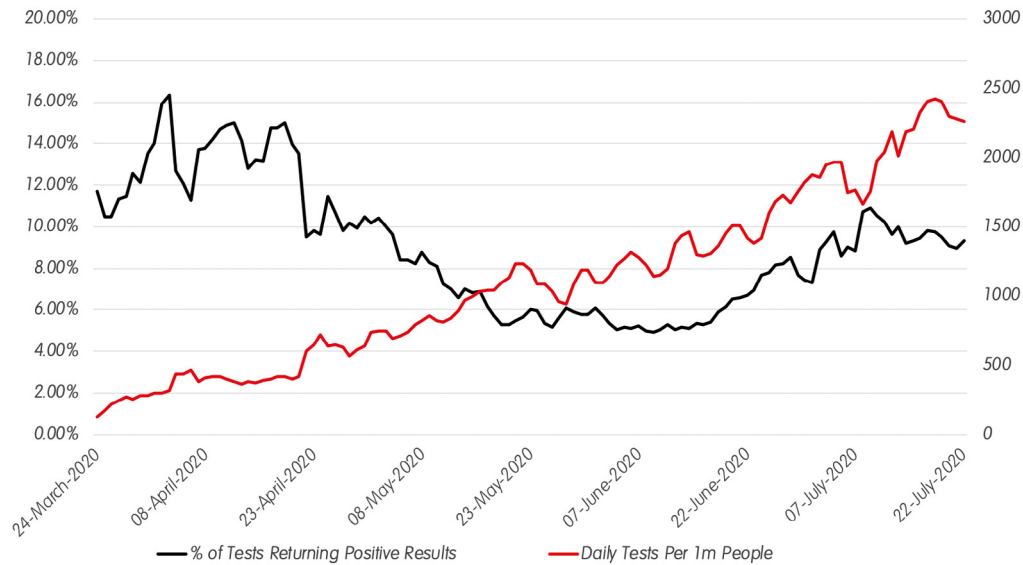
Figure 6: Total COVID-19 cases per 1,000 residents



Source: Montgomery/CDC and state-based agencies

Testing outside of the tristate area, while increasing, remains relatively low. Additionally, the percentage of positive tests has actually increased as the volume of tests has ramped up. This indicates that there is a broad-based problem in terms of the community infection rate that had hitherto been undetected, and strategies to contain the spread of the virus through tracking and tracing points of contact will now be nearly impossible to effectively execute.

Figure 7: Percentage of daily positive COVID-19 tests vs volume of tests – 3 day average, US excluding NY/NJ/CT

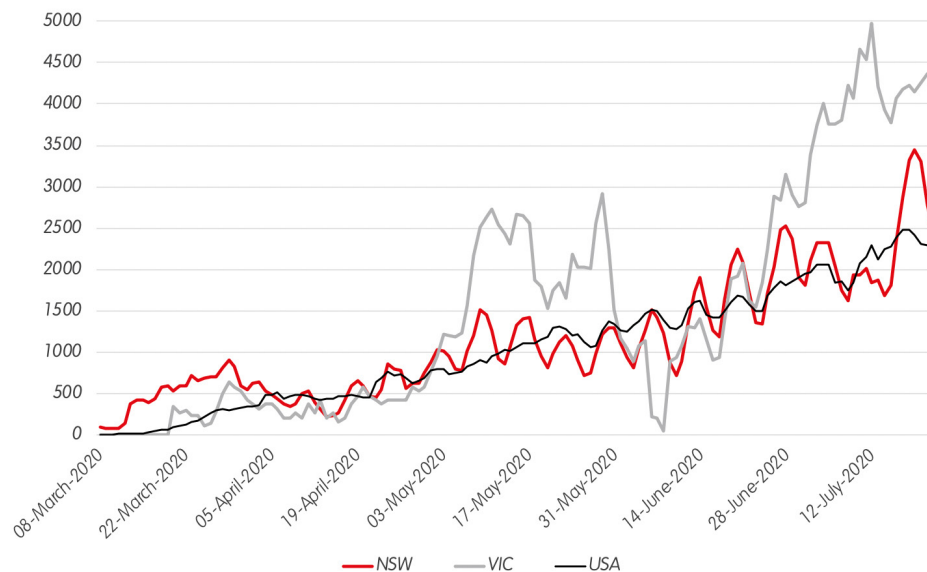


Source: Montgomery/CDC and state-based agencies

Australia is in a far stronger position than the US, with low infection rates and broad-based testing commencing in early March, as opposed to April in the US. The spread of the virus was controlled early through coordinated action by State and Federal Governments, closing the border and ramping up testing relatively quickly. The implementation of lockdowns materially curtailed the spread of the virus in the community, with new inflections largely limited to those returning from overseas.

That was until the recent outbreak in Victoria. Inadequacies in quarantining returning overseas travellers has seen the virus spreading again through the community in Melbourne. Victoria has materially increased its testing and locked down the population, but only time will tell if this will be enough to bring the infection rate under control again in the near term.

Figure 8: Daily tests per 1m population - 3 day rolling average



Source: NSW Health, Victorian Department of Health, CDC

Irrespective of whether Australia can suppress the current outbreak, uncontrolled spread of the virus among vulnerable populations in developing countries like Brazil and India mean the disease will not be eradicated globally. To put this in perspective, if we include the Pan Asian countries of India, Bangladesh and Indonesia, and add Mexico and the US, as well as Brazil, we cover almost 40 per cent of the global population. In all of these countries, for many of which social distancing is impossible, infection rates are rising exponentially.

The only way to keep the virus under control in Australia is to maintain hard border closures and the quarantining of any international arrivals for the foreseeable future. By definition, this restriction reduces the economic capacity of Australia relative to pre-COVID-19 levels.

3. A second wave cannot be met with the same policy response

While much of the fiscal stimulus announced by governments globally has been funded through the monetisation of growing deficits, it will be difficult to offset any second wave of infections, and the associated economic impacts, with another incremental set of stimulus initiatives of the same quantum. Instead, what is more likely is an extension of some or all of the measures announced to date. This will of course see government debt levels balloon further.

But 'more of the same' is unlikely to excite equity markets to the same degree as the original announcements in March, and given already stretched valuations, we see limited upside and increasingly look forward to better value being presented.

Of course, governments could further step up the rate at which they monetise the growing fiscal deficits through quantitative easing, but this comes with an issue for economies like Australia.

4. Fear of rolling lockdowns would negatively impact business confidence

The biggest swing factor in GDP growth tends to be fluctuations in company profits and investment. Falling demand puts downward pressures on company profits, while uncertainty reduces the willingness of businesses to invest capital. Additionally, any subsequent waves of infection, and government containment efforts, will further dampen economic activity and incrementally add to uncertainty until a more permanent solution can be found through a broadly available vaccine. According to Treasury, spending by firms will slump 12.5 per cent in the 12 months through June 2021, after tumbling six per cent in the fiscal year that ended last month.

5. US Presidential election

While COVID-19 has severely restricted campaigning and therefore news flow, the outcome of the US Presidential election on 3 November 2020 will be important for the trajectory of equity markets over the next year.

The need for ongoing fiscal stimulus to support the economy, and those out of work, is likely to see policymakers look at rebalancing and increasing the tax take should there be any shift back toward Democrat-controlled branches of government.

Additionally, the US system of tying health insurance access to employment means that during a health crisis, when unemployment increases materially, large portions of the population suddenly lose not only their income, but also their access to healthcare. As the confirmed case rate grows along with hospitalisation rates, this issue will become increasingly apparent.

The likely result is increased focus on the need for universal healthcare or at least a safety net for those without affordable access to insurance.

This creates a real risk of a partial reversal of corporate tax cuts to pay for an increased and more widely available income and healthcare safety net. Unwinding the corporate tax cuts will put additional downward pressure on US corporate earnings and therefore equity prices.

The longer-term solution? There is really only one

The only permanent solution to this crisis is a vaccine or the adoption of an elimination strategy. In the absence of a vaccine the adverse impact on economic activity continues because the Coronavirus simply doesn't go away. While there are a large number of trials being undertaken globally, the success of these trials remains uncertain.

Table 4., reveals a list of some of the more promising COVID-19 vaccine candidates that are currently in clinical evaluation. While there are a reported 180 vaccine projects globally, there are currently 15 candidates in clinical trials.

Table 4: Candidate COVID-19 vaccines in clinical evaluation

Developer	Manufacturers	Platform	Current Stage of Clinical Evaluation /Regulatory Status	Same Platform for Non-Coronavirus candidates	Clinical Trial Location	Study Start Date	Estimated Study Completion Date	Participants
CanSino Biologics Inc/Beijing Institute of Biotechnology		Non-replicating Viral Vector	Phase 2 Phase 1	Ebola	China	10-Apr-20 17-Mar-20	31-Jan-21 31-Dec-20	108 500
Moderna	AstraZeneca, Merck, DARPA & BARDA (US Govt)	RNA	Phase 3 Phase 2 (IND Accepted) Phase 1	Multiple candidates	USA	27-Jul-20 16-Mar-20	27-Oct-22 20-Sep-21	30,000 45
Wuhan Institute of Biological Products	Sinopharm	Inactivated	Phase 1/2		China	11-Apr-20	10-Nov-21	1,432
Beijing Institute of Biological Products	Sinopharm	Inactivated	Phase 1/2		China	29-Apr-20	28-Nov-21	2,128
Sinovac	Sinovac	Inactivated	Phase 1/2	SARS	China	16-Apr-20	13-Dec-20	phase 1 144 phase 2 600
University of Oxford	AstraZeneca	Non-replicating Viral Vector	Phase 1/2	MERS, influenza, TB, Chikungunya, Zika Meningitis B, Plague	UK	23-Apr-20	1-May-21	1,090
BioNTech Fosun Pharma	Pfizer, BioNTech	RNA	Phase 1/2		Germany	20-Apr-20	8-Mar-23	7,600
Inovio	VGXI Inc, Richter-Helm Biologics, Ology Biosciences	DNA	Phase 1	Multiple candidates	USA	3-Apr-20	1-Apr-21	40

Source: WHO, UBS

One of the most promising currently appears to be the AstraZeneca/Oxford University human trial. The Lancet reported at the time of writing the experimental vaccine produced antibody and T-cell responses in participants in a single-blind, randomized, controlled Phase 1/2 clinical trial. The trial found that neutralizing antibody responses were reported in 91 per cent of 35 patients when utilizing one test and 100 per cent of 35 patients when using a different test. It also found that T-cell responses peaked on day 14.

At the time of writing however, the study does not show that vaccination prevents COVID-19. Instead, the results show that, similar to the season influenza vaccine, vaccinated individuals produce antibodies against the virus, which would reduce the symptoms of a SARS-CoV-2 infection. Large scale trials are now required.

The development of a vaccine generally takes around six to seven years and then a number of years after that to scale up production.

We note former New Zealand Prime Minister, Helen Clark, who is running the World Health Organisation's investigation into China's role in the Coronavirus outbreak, has countered the optimistic claims of quick success, suggesting two and a half years is more likely for a vaccine to be developed, trialled and broadly distributed. In the meantime, Clark has observed *"In the end, a disease like this, like a plague of ancient times, will keep going as long as hosts present themselves for it, so we have to cut the transmission cycle."*

The urgent need for a COVID-19 vaccine has seen large amount of capital and resources deployed globally. While this may accelerate the timetable, there are certain elements of the process regarding testing the safety as well as efficacy of the product that are difficult compress.

Therefore, we need to accept that the current state of uncertainty and restricted activity is likely to persist for longer than many hope.

Stocks and portfolio positioning

Scentre Group

Scentre Group is the owner of the preeminent portfolio of shopping malls in Australia and New Zealand operating under the Westfield brand.

A real estate investment trust might seem like an unusual investment for The Fund. There is no doubt that the bricks-and-mortar retailing landscape is likely to change dramatically over the next five years. The lockdowns and reduced population movement resulting from the COVID-19 pandemic has accelerated the existing structural shift in retail sales to online distribution channels.

In the near term, rental income for real estate owners has been impacted by hardship provisions for tenants that include rent forgiveness and discounts.

In the medium to longer term, the shift in channel mix for retail sales will see some permanent reductions in rent and possibly a degree of sharing of the risk associated with sales performance by increasing proportion of rent being determined on a contingent rather than fixed rate basis. Of course, landlords will object to this and resist its introduction.

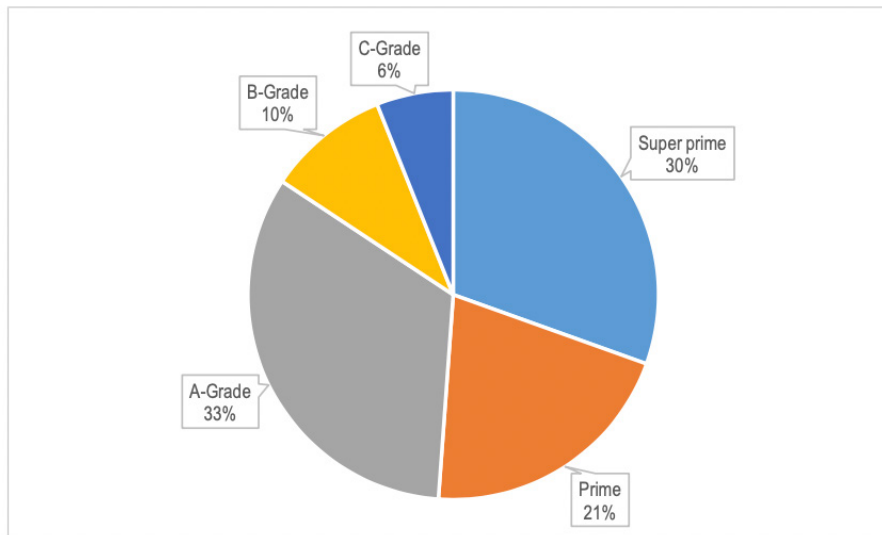
Vacancy rates will also rise as the retail industry rationalises after the reduced spend and traffic in malls.

But not all malls will be impacted equally. Lower quality malls in lower growth areas with weaker surrounding access infrastructure will be impacted far more significantly, and there will be some centres that will become unviable. This will see industry capacity shrink in the medium to long term.

The premier malls that are located in areas with stronger population growth, and have maintained and invested in their assets, will be far less impacted. We believe there will always be a value in retailers offering physical locations as well as infrastructure that provides entertainment precincts. Traffic flow will become even more valued and the dispersion of rents will widen across the industry.

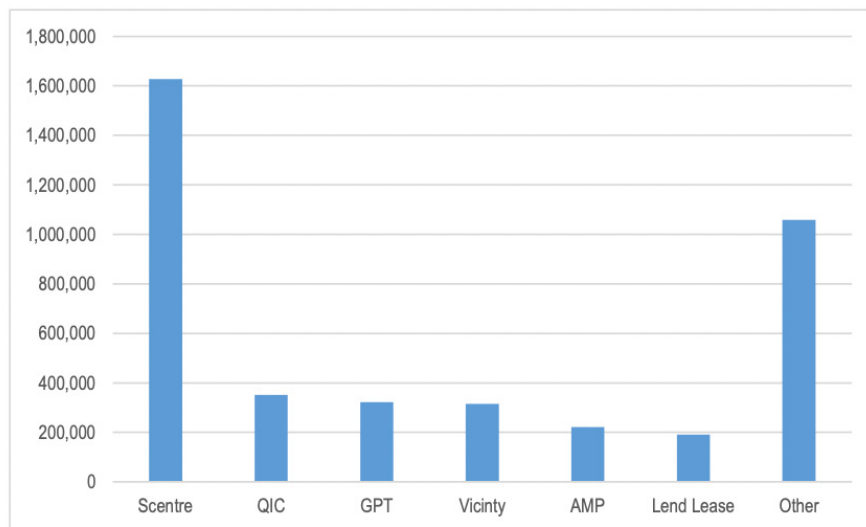
The important thing to recognise is that Scentre Group owns the majority of the premium malls in Australia and New Zealand. It is also a world-class owner, manager and developer of retail assets. As a result, it is likely to experience a smaller decline in rents and occupancy than other mall owners.

Figure 9: Scentre Group property book values split by mall quality



Source: JPMorgan

Figure 10: Quality: Square metres of space owned in the top 40 malls in Australia by sales per m2



Source: JPMorgan

Valuation is always important

As at 31 December 2019, Scentre Group had a reported net tangible asset base of A\$4.46. This was made up of A\$6.66 per share of gross assets less A\$2.20 per share of net debt. The value of the property portfolio will undoubtedly fall on the back of lower rental revenue, increased vacancy, and higher capitalisation rates as the historic above-inflation rental escalators embedded in leases become a thing of the past. However, the current share price implies the asset value will fall by around 32 per cent.

Our channel checks suggest rental reductions across the industry will amount to 15 per cent, but regional rents are likely to fall more than those in key flagship metropolitan malls. Scentre Group's high-quality portfolio is likely to experience a smaller reduction in rents.

To justify the current share price, the average capitalisation rate applied to the portfolio would need to rise from 4.72 per cent at the end of December 2019, to around 6 per cent. Given Australian 10-year bond rates have fallen from around 1.4 per cent at the end of 2019 to 0.9 per cent now, this would imply the yield spread on Scentre's high quality portfolio of assets needs to increase by around 1.7 percentage points after the rent has been rebased down. This is a very pessimistic assumption and offers a good longer-term risk and return dynamic for investors.

Scentre Group has adequate undrawn debt facilities and room in its debt covenants such that the weak trading performance in the near term is unlikely to force it to raise equity. In the long term, the market's excessively pessimistic assumptions around the reduction in the value of its malls are likely to moderate.

There is a material inconsistency in the implied devaluation of retail malls when placed in the context of the performance of retailers and their share prices over the last year, and what that implies about the shift in the value between tenants and landlords across the overall retailing value chain.

Sydney Airport

Sydney Airport generates revenue in the form of charges from international and domestic passengers, as well as retail, car-parking and commercial property. In a normal year, approximately 28 per cent of Sydney Airport's earnings come from domestic passenger movements, while 58 per cent comes from international passengers and 13 per cent from rents received from third parties.

Understandably, the share price has been under pressure given the significant challenges faced by the aviation industry. We believe the current share price provides an attractive entry point to an asset which will most certainly recover as society develops methods to mitigate the spread and infection of COVID-19 over the short to medium term – with increasing demand for global aviation one of the most resilient longer-term trends (September 11, SARs epidemic).

A return to normal demand and volumes is likely to take years with domestic flights to resume first, followed by international flights perhaps later in 2021. Even once flights resume, volumes are likely to remain depressed for some time with passenger confidence regarding safety taking time to be rebuilt. In the international market, flights are likely to resume gradually and from select locations where number of active cases of COVID-19 are low.

While balance sheet leverage remains, we expect Sydney Airport's existing liquidity, along with measures to reduce capital expenditure, deferral of dividends and high-quality retail tenant base to help mitigate the need for a sizeable equity raising.

We regard Sydney Airport as a premier infrastructure asset in Australia. Of course, the longer travel bans continue, the greater the transfer of its enterprise value from equity holders to debtholders. However, the quality of the asset provides it with access to very low-cost debt, which will minimise the rate of debt growth from the compounding of capitalised interest costs.

The opportunity for an investment in Sydney Airports is provided by the fact that the share price has not recovered to the same degree as the rest of the market. There will be an income generation gap in the short to medium term.

However, the long-term fundamentals of the asset – those associated with an eventual return to travel,

as well as growth in middle income households in developing markets – will, we believe, reassert themselves. Sydney Airport remains the main point of entry to Australia and we believe today's share price will be seen as a bargain in the years to come.

Megaport

Many readers will be familiar with the transformation being wrought in the information technology space by cloud computing. Previously an enterprise would own and maintain all of its own computing infrastructure on-premises. Today however, businesses view computing as a non-core activity that is best consumed as a 'service.'

If a third party can operate an efficient and cheaper scaled platform, that offers the necessary back-end data storage, software and processing power on a flexible, "as needed" basis, then it makes sense for an enterprise to outsource to that third party and focus its own resources on more critical parts of its business model.

This logic is being rapidly adopted resulting in the growth of so-called public cloud computing providers, led by Amazon Web Services and Microsoft Azure. The global cloud computing market is now estimated to be worth \$200 billion to US\$300 billion annually and is expected to continue growing at double digit rates.

As data and computing loads increasingly move from on-premises to the cloud, a corresponding need arises for networking capacity to transfer data from one place to another. To meet this need, enterprise users will typically contract with telecommunications companies and other parties to access the required networking equipment and fibre optic lines.

In recent years MegaPort has taken the approach of offering network connectivity to cloud providers in the same way that public cloud providers offer computing capacity – flexibly, and as a service.

MegaPort has installed networking equipment (“MegaPorts”) in hundreds of data centres around the world and put in place a network linking together these MegaPorts and the major public cloud service providers.

Via its platform, enterprises who would take advantage of the ease and flexibility of cloud computing can now access the associated network capacity in the same flexible way (Network as a Service, or NaaS), freeing them to focus resources on more critical parts of their business model.

It is still early days for the NaaS industry, but since launching in 2013, MegaPort has moved to quickly build out a global footprint and has enjoyed very rapid growth in the take up of its services. It now appears to be the global leader in an interesting business with a very large growth opportunity before it.

While we will closely watch for any changes in Megaport's competitive position, we are encouraged by its leading position today and its scale benefits and first mover advantage. Assuming the cloud NaaS industry develops to be an order of magnitude smaller than the cloud computing market it serves, our analysis suggests that the opportunity in front of Megaport is huge, with the potential for very rapid compound growth to continue many years into the future.

Megaport has achieved an enviable position in its industry and if it is able to sustain this position, the upside for investors is material.

Concluding observations

The bare fact is that more than half a year has passed since the coronavirus emerged and many of the world's most-populous countries are failing at their attempts to flatten their curves.

One reasonable assumption is that these countries are so large that control of disparate outbreaks cannot be nationally coordinated.

Under-resourced local law enforcement and health regulators are left to take control. Millions of tests are required and contact tracing in some of these countries is simply impossible either because of perceived invasions of privacy or the absence of technology.

In the absence of a vaccine or government income support, it appears that a return to 2019 levels of incomes for broad swathes of the general population is some years away. We are in a recession, which without wage subsidies would be the worst in many generations. Interest rates settings must therefore remain at historically low levels and central bank liquidity support will also remain a feature. These latter measures have fuelled the stock market's enthusiasm since March.

Importantly, while The Montgomery [Private] Fund holds a conservative level of cash, we are positioned for the development of a vaccine, through for example, holdings in toll road operator Atlas Arteria, as well as Sydney Airports and Scentre Group. Whilst benefitting from a continuation of a lower interest rate regime, Sydney Airports is also particularly leveraged to the development of a vaccine, which would of course see international travel return sooner than presently expected.

In mid-May, former treasurer Peter Costello observed, when referring to the stock market's optimism, *"Markets have decided the crisis is over...I've got to say, it's a pretty optimistic view that it's all over now...I don't know that it really makes a big enough allowance for... that even when we do come back, we're not going to come back to 100 per cent of where we were."*

Much of the market's strength has also been driven by optimism for technology companies. In many cases the thesis for buying technology makes sense; Microsoft for example will benefit from an increased number of people working from home. The strength in many reputable and profitable technology companies is therefore confirmation of the belief that this pandemic will be around for much longer than current mainstream commentary seems to suggest.

But if that's the case, is the stock market's enthusiasm rational? While the thesis for buying technology might be rational, paying any price to gain exposure to that theme is not.

Keep in mind of course all booms start with a legitimate and credible thesis. As that thesis gains acceptance, it also gains momentum, and many less sophisticated investors jump aboard.

Eventually investors pile in, not on the basis of the original thesis, but simply because the shares keep going up. Eventually, prices become so extreme they bear no relationship to reality and a bubble forms. I believe we are there today, not for all stocks but for many in the technology space.

While there is merit in the idea that COVID-19 lockdowns have accelerated the trend to digitisation of work, entertainment and logistics, there is little doubt the rally in technology stocks has also been extended by a veritable tidal wave of debutante investor buying.

Over the past five years, the FAANG stocks increased profits by \$80 billion but their market capitalisation increased by \$4.4 trillion. That represents an expansion of the price to earnings multiple of 55 times! And, according to Gavekal Data, if one removes the US market from the MSCI World Index, the rest of the world has gone nowhere, in aggregate, for six years.

The strength in US markets broadly is despite S&P 500 earnings forecast to fall 20 per cent year-on-year over the next four quarters, according to analysts surveyed by Refinitiv. This represents a significant turnaround from the 10 per cent growth forecast before COVID-19 hit.

Consequently, the S&P 500 now trades at more than 22 times expected earnings, putting its forward P/E into territory last seen during the dot-com bubble.

In the US, where for example California is reversing its reopening agenda after skyrocketing coronavirus cases, companies went into the crisis with record levels of corporate debt. Many are taking on more and the inevitable period of deleveraging that follows will mean lower levels of employment.

Meanwhile the number of corporate bond defaults is rising in the US. In the second quarter a record US\$95 billion in face value of non-financial corporate bonds defaulted.

So, we have an economic crisis and a health crisis

Fortunately, we do not have a financial crisis. But is merely the absence of a financial crisis justification for such high stock market multiples? Recessions have a negative impact on company revenues and profits, and I fear history will show there is nothing unique about this recession's impact on the stock market. Companies go broke and the equity in those companies becomes worthless.

Meanwhile central bank conventional and unconventional monetary policy can only keep a company's interest rates low. Monetary policy at the zero bound cannot bring a failing company new customers. It cannot deliver revenue. And as we have mentioned above, it does not appear to be limiting the quantum of defaulting on the debt obligations. Consequently, it is reasonable to expect much higher levels of bankruptcies and defaults than we have already seen.

As these businesses fall over, many employees who currently expect to go back to work will not have a job to return to. Hence our belief in a slow and halting recovery rather than an easy and quick one.

For professional investors it is time to be cautious

No fund manager or analyst can see the shape of employment and therefore true consumption because government largesse in the form of wage subsidies has replaced wages of those furloughed. Spending patterns must and will therefore change. Predicting those changes while government handouts remain in place is next to impossible.

Having some cash in this environment makes sense and so does reducing the 'beta' or risk of the portfolio.

Investors would be wise at this juncture to consider whether expectations of an imminent end to the pandemic are premature.

If a vaccine is not developed, and first and second COVID-19 waves send cities and countries back into lockdown, keeping borders closed, then the unbridled enthusiasm currently gripping markets is equally misplaced and premature. It is therefore worth considering what is not currently expected and at least acknowledge that risk as we have done.

The consequence is we look foolish for apparently missing full participation in a rally but that rally may turn out to be temporary.

We are in the midst of an evolving black swan event. Investors however have been anesthetised by the extreme volatility in March and seem to be underestimating the realities and impact of the COVID-19 recession.

What will always remain are idiosyncratic opportunities. In addition to appreciating the risks, investors should be cognizant that there will be companies that emerge stronger than they entered the crisis. Those whose equity was not diluted by deeply discounted capital raisings, those that will return to an environment with weakened or reduced levels of competition, and those that will enjoy a surge in sales from pent-up demand and the aforementioned support from fiscal and monetary policy, will be favoured by investors still looking over their shoulders for black swans and fat-tail risks.

We are positioned to invest The Fund's remaining cash in those opportunities, and as we demonstrated in March, we are relatively well positioned to protect and preserve capital amid any relapse.

Thank you. We appreciate the opportunity to work for you and look forward to continuing our investment partnership through FY2021 and the years that follow.

Sincerely,

A handwritten signature in black ink, appearing to be 'Stuart Jackson', written in a cursive style.

Stuart Jackson
Portfolio Manager
The Montgomery [Private] Fund

A handwritten signature in black ink, appearing to be 'Roger Montgomery', written in a cursive style.

Roger Montgomery
Chairman and Chief Investment Officer
Montgomery Investment Management Pty Ltd

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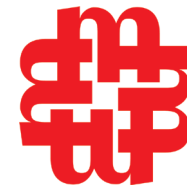
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