

INVESTMENT REPORT & FACT SHEET

FUND OVERVIEW

The Montgomery Global Equities Fund (Managed Fund) (the Fund) employs a highly disciplined, bottom-up, value style and typically invests in 15 to 30 high conviction stocks listed on major global stock exchanges. The focus of the Fund is on investing in what Montgomery Global regards as high quality businesses with attractive prospects trading at a discount to their estimated intrinsic value.

The Fund has the flexibility to retain a reasonable level of cash, with a "soft" 30 per cent limit. The Fund will generally be currency

unhedged but we can put in place strategies aimed at protecting investor capital against currency fluctuations if we predict material upside to the Australian dollar.

The Fund aims to deliver superior positive returns when suitable investment opportunities are abundant, and to preserve capital through cash allocations when an insufficient number of company names are appealing. The Fund also aims to target a minimum 4.5% annual distribution yield, paid semi-annually.

FUND FACTS

INVESTMENT MANAGER

Montgomery Global Investment Management Pty Ltd

OBJECTIVE

The Montgomery Global Equities Fund (Managed Fund) aims to outperform the index over a rolling 5-year period.

BENCHMARK

MSCI World Net Total Return Index, in Australian dollars.

ASRN

621941508

RECOMMENDED INVESTMENT TIMEFRAME

5 years

INCEPTION DATE

20 DECEMBER 2017

FUND SIZE

\$62.1 M

MANAGEMENT COST

1.32% per annum, inclusive of GST/RITC.

PERFORMANCE FEES

15.38% of the total return of the Fund that is in excess of its Benchmark. No performance fee is payable until any previous periods of underperformance has been made up.

APPLICATION & REDEMPTION PRICES

montinvest.com/mogl

PERFORMANCE GRAPH



Performance Graph Monthly Index: \$100,000 = MOGL inception date²

CONTACT DETAILS

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PORTFOLIO PERFORMANCE (to 31 December 2017, after all fees)

	INCOME	CAPITAL GROWTH	FUND RETURN	MSCI WORLD NET TOTAL RETURN INDEX ¹	OUT/UNDER PERFORMANCE
MOGL (since inception) ²	0.00%	-2.18%	-2.18%	-1.63%	-0.55%
MGF (since inception) ³	12.10%	19.51%	31.61%	23.75%	7.86%

¹ In Australian dollars ² Inception: 20 December 2017 ³ Inception: 1 July 2015

FUND COMMENTARY

Welcome to the inaugural investment report for the Montgomery Global Equities Fund (Managed Fund), or “MOGL” by which the Fund is represented on the ASX. While many investors have invested with Montgomery in the past, many are also new to the Montgomery family. To our new investors: welcome! We will provide investors with a brief investment report each month, as well as a longer report at the conclusion of December and June each year. The longer reports will typically include a case study on a business owned by the Fund. We strive to do more than generate superior returns for our investors. We strive to educate and provide transparency into our investment process to grow and strengthen our partnership with our investors over time.

The Fund’s inception date was 20 December, 2017. In the month of December following inception, the Fund declined by 2.18 per cent, net of fees. Over the same period, the MSCI World Total Return Index in Australian dollar terms (the Global Market) declined by 1.63 per cent. Given the very short time period since the Fund’s inception, these return figures are not particularly meaningful, in our view.

The performance chart shown on the first page includes reference to the Montgomery Global Fund (MGF). We believe this is relevant and interesting to MOGL investors since the two funds share the same strategy. Over the 30 months since MGF’s inception, MGF has delivered a return of 31.61 per cent, net of fees. By comparison, the Global Market delivered 23.75 per cent over the same period.

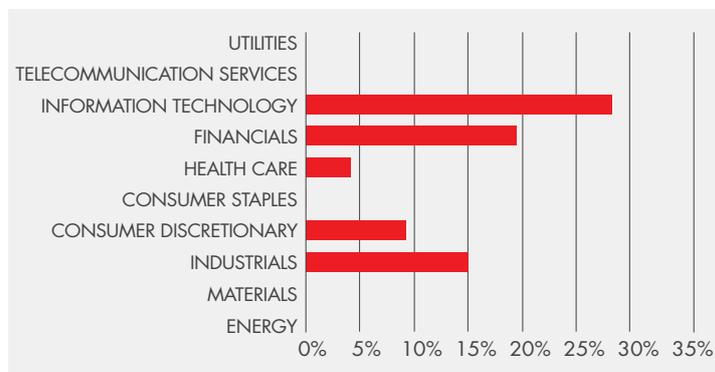
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TOP COMPLETED HOLDINGS* (TCH) (at 31 December 2017, out of 22 holdings)

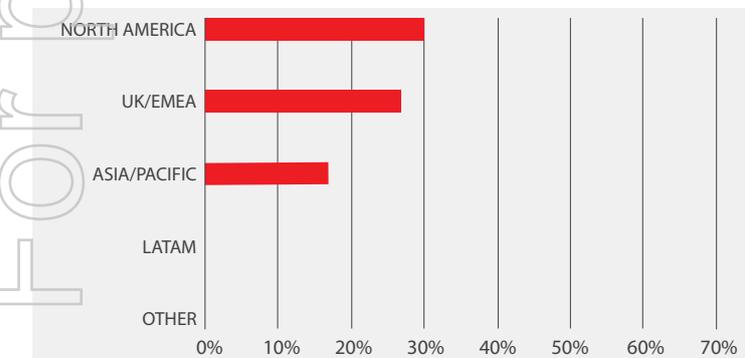
COMPANY NAME	COUNTRY OF DOMICILE	MARKET CAP (\$USDM)	WEIGHT (%)
St James's Place	GB	8,763	5.7
Union Pacific	US	105,559	4.6
Rea Group	AU	7,881	4.4
Facebook	US	514,985	4.4
Insperty	US	2,391	4.2
NetEnt	SE	1,658	4.2
Apple	US	860,882	3.9
Jupiter Fund	GB	3,886	3.9
Alibaba	CN	441,620	3.6
Essilor	FR	30,229	3.5
PORTFOLIO MEDIAN		60,187	3.4
Total equity weighting			74.2
Total cash weighting			25.8

*Top Completed Holdings are businesses we own but are not actively buying or selling at the time of writing.

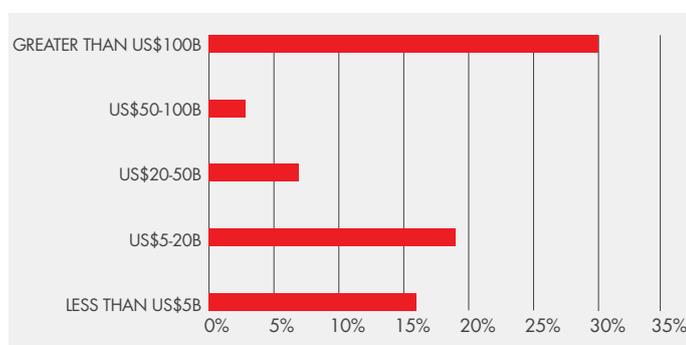
GICS SECTOR INDUSTRY EXPOSURE



GEOGRAPHIC - COUNTRY OF DOMICILE



MARKET CAPITALISATION EXPOSURE



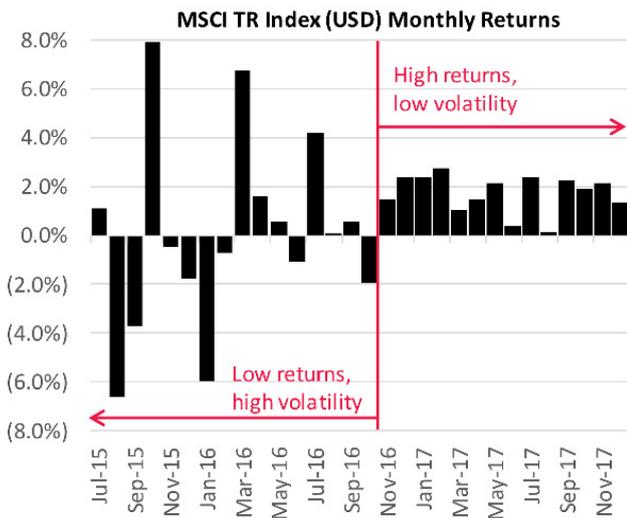
#Portfolio Performance is calculated after fees and costs, including the investment management fee and performance fee, but excludes the buy/sell spread. All returns are on a pre-tax basis. This report was prepared by Montgomery Global Investment Management Pty Ltd, (ACN 604 878 533) (CAR) #001 007 050 (Montgomery) the investment manager of the Montgomery Global Equities Fund (Managed Fund). The issuer of units in Montgomery Global Equities Fund (Managed Fund) is the Fund’s responsible entity Perpetual Trust Services Limited ACN 000 142 049 (AFSL 236648). Copies of the PDS are available from Montgomery Global Investment Management (02) 8046 5000 or online at www.montinvest.com/mogl Before making any decision to make or hold any investment in the Fund you should consider the PDS in full. The information provided is general information only and does not take into account your investment objectives, financial situation or particular needs. You should consider your own investment objectives, financial situation and particular needs before acting upon any information provided and consider seeking advice from a financial advisor or stockbroker if necessary. You should not base an investment decision simply on past performance. Past performance is not an indicator of future performance. Returns are not guaranteed and so the value of an investment may rise or fall.

FUND COMMENTARY

Calendar 2017 can be characterised as a year of strong and stable returns for global equity investors. First, the year delivered strong annual returns with the MSCI World Total Return Index increasing by 22.4 per cent (in US dollar terms).

Second, these global equity returns were delivered with unusually low volatility. Consider the chart below that illustrates the monthly returns of the global equity market since the Fund’s inception.

One can clearly observe a near-collapse in volatility from November 2016.



Source: Bloomberg

This extremely low level of variability in monthly returns was surprising to us, especially in light of 2017 being a year in which historians will look back and mark a genuine shift in the World Order. Significant changes in the domestic politics – and political systems – of the following nations were observed during the year:

- The United States – the election of President Trump and subsequent (ongoing) challenging of the nation’s Constitution;
- Russia – the ongoing consolidation of power by President Putin and the rise in his outward brazen attacks on foreign democracies;
- China – the complete consolidation of power by an increasingly authoritarian President Xi;
- Saudi Arabia – the complete consolidation of power by an increasingly authoritarian MBS;
- North Korea – the attainment of an intercontinental ballistic missile capable of reaching the east coast of the United States; and
- The United Kingdom – the ongoing and muddled extrication from the European Union.

With so much geopolitical change occurring in one year, how was it that global equity markets were able to deliver an average 1.7 per cent monthly return, almost like clockwork?

In our view, this remarkable set of strong and stable monthly returns was the result of the Goldilocks economic conditions to which we have referred in the past. That is, global economic conditions have strengthened; while at the same time, global monetary conditions have remained highly-accommodative. For equities in general, this

loosely translates into accelerating revenue and earnings growth, generated by assets funded with abundant and low-cost sources of capital. Good times, in other words.

Indeed, according to the IMF, 2017 marked the “broadest synchronized upswing the world economy has experienced in the last decade.”¹ And in our view, this is the most noteworthy theme of the year – in large part because very few would have predicted as such as recently as two years ago. But the combination of an enormous and globally coordinated economic stimulus in early 2016, combined with economically-friendly election results in the US and Europe, has led to a favourable set of global economic conditions, the likes of which we have not observed for some time.



Source: IMF

By way of example, consider the US economy, the world’s largest and therefore one of significance to any global investor. We would argue that this economy is in the midst of a “triple dose” of economic stimulus:

1. Monetary conditions remain highly-accommodative with the target range of the Federal Funds Rate at 1.25-1.50 per cent; and Federal Reserve balance sheet assets at US\$4.5 trillion. Most would consider these levels to reflect “emergency settings” of monetary policy.
2. Since the beginning of the calendar year, the US Dollar Index – a trade-weighted average US dollar exchange rate – has declined by more than 10 per cent. This is an effective form of stimulus in the sense that US goods and services are 10 per cent cheaper in foreign currency terms – and therefore, in greater demand.
3. In the days prior to Christmas, President Trump signed into law the largest set of changes to the US tax code in more than three decades. Officially, this is a US\$1.5 trillion tax cut, though in practice, it will likely be a significantly larger cut to US tax revenues than this. From an economic perspective, this is a genuine and significant fiscal stimulus of the US economy in the short to medium term.

Many of the businesses we own on behalf of our investors are benefiting from the dynamics described above – both in the US and abroad more generally. We believe it is of critical importance to monitor closely the economic and geopolitical developments in the world. It is the interpretation of these observations that shape our judgement for the prospects of any potential investment opportunity.

1 (IMF) A Firming Recovery, July 2017

FUND COMMENTARY

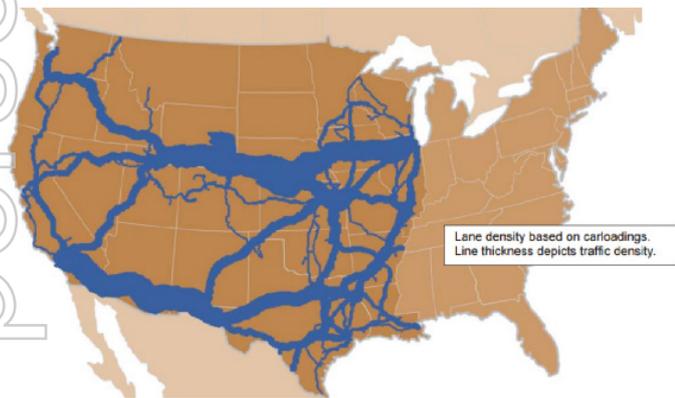
That said, what matters most for any business we own is what is already priced into the stock. And this forms the basis of our Expectations Framework for investing. Put simply, our framework leads us to: (i) identify the key value drivers of the business we are evaluating; (ii) reverse engineer what the current stock price is implying about the market’s expectations for each of these value drivers; and (iii) evaluate the reasonableness, or otherwise, of said expectations.

If the market’s expectations for the key value drivers of a business look reasonable, then there is no investment opportunity. No matter the quality of the business or the strength of any tailwind it might be experiencing: if the market has already priced in these factors, then there is no case for owning the stock. Only if the market’s expectations are unreasonably conservative is there a case to own a stock.

By way of example, we examine a case study on Union Pacific (NYSE: UNP), one of the largest rail businesses in the US and a top 10 holding by the Fund. What is key in this example is not the quality of the business – though it is an extraordinarily high-quality business, but rather the market’s expectations for this business, which we believe remain too conservative given the favourable conditions that this business will experience medium-term.

CASE STUDY: UNION PACIFIC

UNP is one of the few Class I rail businesses in the United States that links 23 states in the western two-thirds of the country with over 32,000 miles of rail. Shown below is the geographical footprint of UNP’s business with the line thickness depicting traffic density. UNP owns a highly-critical segment of the US and global supply chain that is effectively impossible to recreate.



Source: UNP

In addition to owning a highly-valuable and scarce asset, UNP benefits from favourable competitive conditions. We view the market as being fairly “cooperative” and believe the industry has organised itself into three geographic duopolies:

- UNP and BNSF (owned by Berkshire Hathaway) in the mid-west;
- CSX and NSC in the east; and
- CP and CNR in the north (primarily Canada).

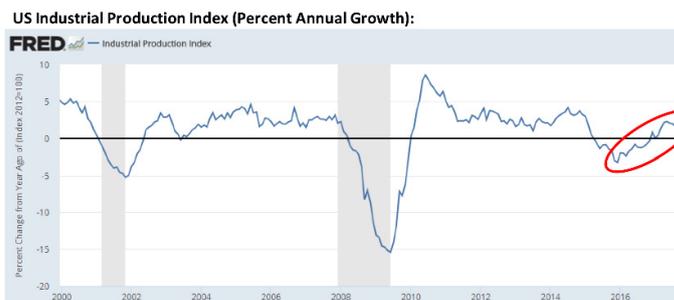
While competition is the friend of the consumer, cooperation is the friend of the shareholder.

UNP’s demand drivers are diversified and resilient in nature. The table shown below illustrates the split of UNP’s operating revenues.

Segment	Share of 3Q17 revenue
Agricultural	17%
Automotive	9%
Chemicals	17%
Coal	13%
Industrial Products	20%
Intermodal	18%
Other	7%
Subtotal	100%

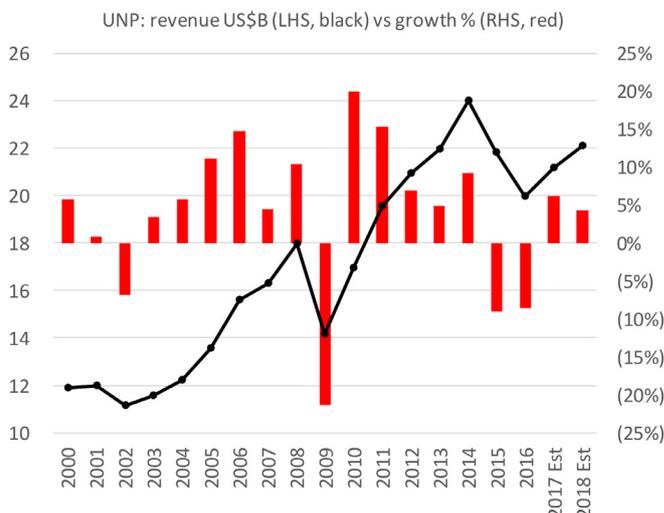
Source: UNP

Given this diversification, UNP’s volume growth is substantially driven by the real industrial growth of the US economy in general. And this has been one aspect of the US economy that has been strengthening recently, as illustrated below.



Source: FRED

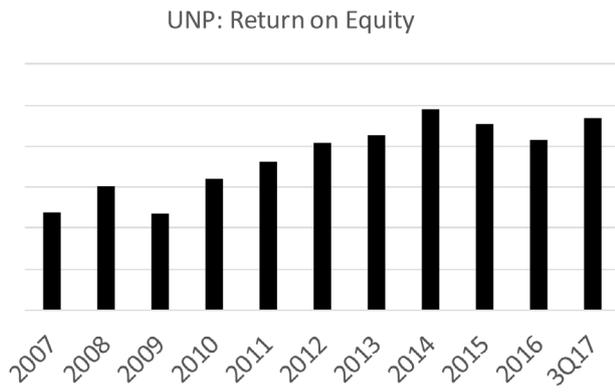
Over the longer term, UNP’s revenues have grown at an average rate of more than four per cent per annum, as illustrated in the chart below. This rate of growth appears sustainable and can be rationalised as, say 2.5 per cent of real industrial growth in the US, plus 1.5 per cent of pricing power – which itself is conservative, especially in light of the current truck driver shortage in the US which is driving up rates for the only real substitute to rails.



Source: Bloomberg

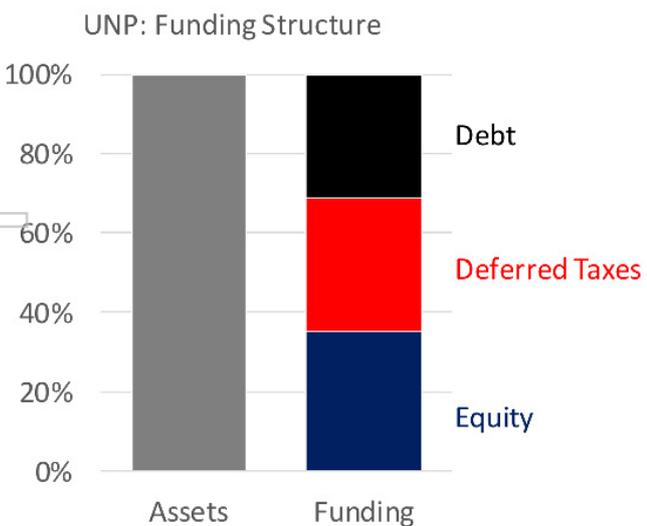
FUND COMMENTARY

A study of UNP’s historical financials further supports our hypothesis that UNP is a very high-quality business. Cash flows have more than matched earnings; the balance sheet remains clean; and UNP’s post-tax returns generated on shareholder equity have remained north of 20 per cent for the last five years (as shown below). It should also be noted that UNP’s effective tax rate for reported earnings has historically averaged 38 per cent. Under the new Trump tax plan beginning 2018, this effective tax rate will nearly halve!



Source: UNP; MGIM

One underappreciated aspect of UNP’s business model is its very low-cost funding structure. As illustrated below, UNP’s business assets are funded in part by equity, debt and deferred tax liabilities (DTLs). These DTLs stem from timing differences between the taxes provisioned for financial reporting and the taxes actually paid as required under tax reporting. Economically, they can be equivalent to an interest-free loan from the US government. One can intuitively see, therefore, that UNP’s blended cost of funding is very low. DTLs cost nothing, debt costs UNP around 2.5 per cent in US bond markets at present and the remainder is equity.



Source: UNP; MGIM

Another underappreciated aspect of UNP’s business model is the extent to which it stands to benefit from the Trump tax plan beginning 2018. There are three key ways in which UNP stands to materially benefit from the new tax law:

1. From the reduced corporate rate of taxation to 21 per cent (from 35 per cent previously);
2. From the five years of full expensing of new capital investment, followed by the five subsequent years over which this rule will be phased back out again; and
3. From the resulting boost to economic growth in the US which should drive incremental demand for shipments by rail.

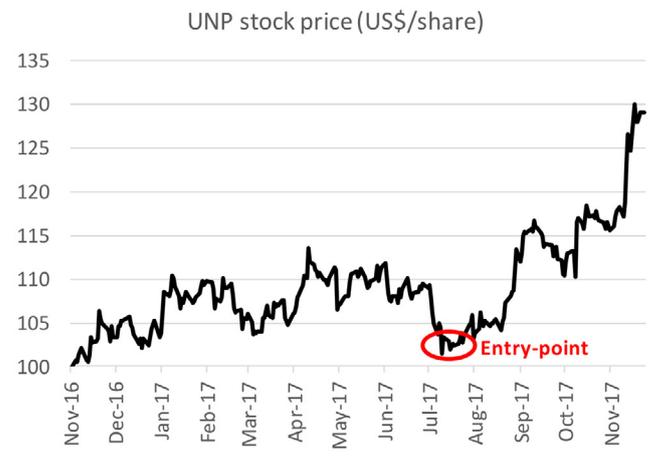
UNP currently provisions taxes at an effective rate of 38 per cent, spends the equivalent of roughly half of its pre-tax earnings in new capital investment each year and is entirely levered to the growth of the real economy. Given this, we struggle to imagine a business that will stand to benefit from Trump’s tax plan relatively more than UNP.

That said, none of this analysis is helpful if the above has already been priced in by the market. Upon applying our Expectations Framework, we believe the market is effectively implying an average revenue growth rate of only 2.5 per cent per annum. This is not only well below the historical average, it is also well below the rates of demand growth we expect to see over the medium term as the US economy strengthens from its “triple dose” of stimulus it is currently experiencing.

When the expectations being implied by the market price of a stock are too conservative, we are interested. In UNP, we believe we have identified a high-quality business positioned in the right market at the right time with market-implied expectations that remain too conservative. Said another way, we believe this stock is materially undervalued.

To round out this case study, our investment in UNP has illustrated a subtle, yet important, distinguishing feature of our global research team: agility. We are a relatively small, flat team of generalists that continually test and evolve hypotheses as a team. Our research process is designed to ensure we only buy businesses when the reward-to-risk ratio is sufficiently high; and our discipline ensures we are patient to wait for the right entry-point.

We have followed UNP in detail for many years but it was only in late July when we believed the time was right to build a position based on the conservative nature of the market-implied expectations of the stock price at the time. A decision to invest that could take months in other research teams took us only days. This agility to act is a source of great advantage for our investors as it allows us to move quickly to pounce on opportunities as and when they present themselves.



Source: Bloomberg; MGIM

FUND COMMENTARY

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In our review of calendar 2017, we identified the strong and synchronized economic growth being observed in many key regions in the world, including China, the US, the EU and Japan. At the same time, we noted the highly-accommodative monetary policies that continue to persist as we enter 2018. The first-order outlook for 2018, therefore, is a continuation of these wonderful Goldilocks conditions that have served global equity investors so well for nearly two years.

And yet, we have built a healthy dose of conservatism into the Fund's portfolio – the evidence for which can be observed in our 25.8 per cent cash weighting. The obvious question, of course, is: why so conservative if conditions are so favourable?

It is not the first-order outlook that concerns us. It is the second-order possibilities that may stem from our first-order outlook that give us pause.

Top of our list of risks to be wary of is the Federal Reserve's normalization of its US\$4.5 trillion balance sheet. Flagged in 2017 to be gently unwound over many years, the Fed may be forced to accelerate its unwinding – pushing longer-term interest rates upwards – as a direct result of the US economy overheating.

It may sound strange to hear of a major economy "overheating" given the preceding decade of sluggish global growth and low levels of inflation. But the Fed believes that the US economy was already operating at its capacity in 2017. And this was before the Trump tax cuts were signed into law.

There are two key reasons why equity investors need to be wary of the Fed's monetary tightening, in our view:

1. As interest rates rise, lower-risk assets, such as bonds, become relatively more attractive than higher-risk assets, such as equities. Under this scenario, capital that has been flowing into equity markets over recent years may reverse course; and
2. The impact of higher borrowing costs for corporates, households and governments can act as an anti-stimulus for the real economy. In particular, consider that US Federal-Debt-to-GDP ratio is a little over 100 per cent – with the majority of this debt maturing in less than five years. This means that, for every one percentage point increase in interest rates, higher government interest repayments will result in around a negative one per cent contribution to GDP growth. This would be a significant drag on economic growth.

The second key risk to be wary of in 2018, in our view, is a slowing of the Chinese economy. All global investors need to focus on the health of the Chinese economy given it has accounted for approximately 40 per cent of total global economic growth over the last decade.

We believe there are two dimensions to a potential Chinese economic slowdown – the first is widely known, while the second is underappreciated:

1. China's growth miracle of the last decade has been largely credit-fuelled and focused on fixed-asset investment. It remains to be seen if there will be genuine write-downs of loans that have funded this investment which could create liquidity problems in the country's US\$15 trillion wealth management sector; and
2. There are increasing indications that the Trump Administration will effect retaliatory trade policies against China in 2018. But unlike many of Trump's proposals, such punitive measures being drafted are reportedly gaining support from both Republicans and Democrats in the Congress.

These are the major risks we are focused on as we enter the new calendar year. We have been surprised by the unusually low variability of global equity market returns in 2017. And while we would hope these conditions continue, this is not a sensible use of time for us. Instead, we are paid to continually evaluate what could happen (not what will happen) and ensure the Fund is positioned appropriately for all possibilities.

We continue to own a portfolio of high-quality global businesses that should remain resilient across a range of global economic conditions. And, of course, what is most important for us is that we believe the market's expectations for these businesses remain too conservative. That is, we believe the stocks we own remain materially undervalued.

* * *

In closing, we would like to take this opportunity to make a special thanks to the entire Montgomery Global team. It has been a year of very hard work by each member of the team. We are proud of our results for the year and look forward to working at least as hard again for our investors in 2018. Finally, we thank each of our investors and readers for their trust and ongoing support. From all of us at Montgomery Global, we wish you a happy and prosperous new year.