ROGER MONTGOMERY

Re-inventing the way you invest

For What It's Worth

A Montgomery White Paper

MARCH 2014

Beyond stands out in depressed media arena

A strong balance sheet underpins growth of television production house.

Do we really need economists?

An insight into the relationship between the economy and your returns.

Beyond stands out in depressed media arena

A strong balance sheet underpins growth of television production house.

Investors could be forgiven for ignoring traditional media stocks, even after horrendous share-price falls in recent years. A fragile Australian economy and changing media consumption habits remain significant threats. Sadly, value is still an illusion for most media stocks.

Fairfax Media, Ten Network Holdings and APN News & Media have been portfolio landmines in the last five years. They may have bounced off last year's price lows, especially Fairfax, but each stock appears to be overvalued, and none have an easy future.

Seven West Media – owner of the Seven Network, Pacific Magazines and several West Australian newspapers – has a three-year average annualised loss of 17 per cent. The recently floated Nine Entertainment Co. is trading above its $2.05 issue price after a slow start, but looks fully valued at $2.25.

Investors seeking exposure to 'cyclical growth stocks' are better off chasing high-quality housing-related companies such as Cedar Woods Properties or star retailers such as JB Hi-Fi. Those seeking media exposure, and who can tolerate higher risk, should look beyond the obvious names.

A standout for value investors is television production house Beyond International, which still trades slightly below its intrinsic value – but has significant liquidity risk.

The small-cap company made 44 per cent of its 2012-13 revenue from TV production and copyright, mostly for factual entertainment, family programs and documentaries. It has produced more than 5,000 hours of global TV programming since 1984, and is best known for its early hit, *Beyond Tomorrow*.

Its popular current shows include *MythBusters*, which has a bigger following overseas than in Australia, and the increasingly popular *Selling Houses Australia*. Beyond clearly has a knack for developing long-running series for TV broadcasters, and selling them offshore.

Another 22 per cent of revenue comes from Beyond's offshore business, which distributes TV programs and films, and is headquartered in Dublin. Beyond says its catalogue has more than 4,000 hours of programming across a wide range of genres, although many programs are not well known here.

Beyond's Home Entertainment division also contributed 22 per cent of FY13 revenue. It holds about 2,000 licensed titles, and distributes and markets them to key retail, rental and online markets. Rugby league lovers, for example, might buy State of Origin DVDs promoted by Beyond.

The remaining 11 per cent of revenue came from the digital marketing division, which offers search-engine optimisation, website creation, and an online media sales service in Australia and New Zealand. The division, still making losses, has good long-term prospects as mainstream advertisers migrate to digital media and lead-generation services.

Geographically, Beyond made just over half its FY13 revenue in Australia. The United States accounted for just

continued on page 4

WELCOME TO THE BOUTIQUE INVESTMENT MANAGEMENT OFFICE OF MONTGOMERY

Since its inception The Montgomery [Private] Fund has meaningfully outperformed.

How?

Unlike funds managed by much larger institutions, The Montgomery [Private] Fund is not forced to be fully invested at all times.

So when markets are volatile and preserving wealth is paramount, Montgomery can turn to cash.

Returns to 28 February 2014

Code	Index	Change	Outperfomance
MPF	**The Montgomery [Private] Fund**	**44.87%**	**-**
XNAJI	ASX 200 Industrials Accumulation Index	20.67%	24.20%
XTOAI	ASX 100 Accumulation Index	33.21%	11.66%
XJOAI	ASX 200 Accumulation Index	30.15%	14.72%
XAOAI	All Ordinaries Accumulation Index	27.31%	17.56%
XKOAI	ASX 300 Accumulation Index	28.47%	16.40%
XTLAI	ASX 20 Accumulation Index	37.52%	7.35%
XMDAI	ASX Midcap 50 Accumulation Index	14.58%	30.29%
XSOAI	ASX Small Ordinaries Accumulation Index	-14.23%	59.10%

Benchmarked returns are since inception (23 Dec, 2010) of the Montgomery [Private] Fund and assumes distributions are reinvested. Past performance is not indicative of future performance.

Minimum investment $1,000,000

MONTGOMERY

Click here for more information and to find out whether you are eligible.

Investment Manager Montgomery Investment Management Pty Ltd | ABN 73 139 161 701 | AFSL 354 564 | GPO Box 3324 Sydney NSW 2001 | 02 8046 5000 | www.montinvest.com | office@montinvest.com Trustee Fundhost Limited | ABN 69 092 517 087 | AFSL 233 045 # 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 Investment Management Pty Ltd, AFSL No: 354564 ("Montgomery") the investment manager of The Montgomery [Private] Fund. The Trustee and Administrator of the Fund is Fundhost Limited (ABN 69 092 517 087) (AFSL No: 233 045) ("Fundhost"). This document has been prepared for the purpose of providing general information, without taking account your particular objectives, financial circumstances or needs. You should obtain and consider a copy of the Information Memorandum ("IM") relating to the Fund before making a decision to invest. While the information in this document has been prepared with all reasonable care, neither Fundhost nor Montgomery makes any representation or warranty as to the accuracy or completeness of any statement in this document including any forecasts. Neither Fundhost nor Montgomery guarantees the performance of the Fund or the repayment of any investor's capital. To the extent permitted by law, neither Fundhost nor Montgomery, including their employees, consultants, advisers, officers or authorised representatives, are liable for any loss or damage arising as a result of reliance placed on the contents of this report. Past performance is not indicative of future performance. Applications to invest in The Montgomery [Private] Fund are only considered from wholesale investors or investors willing to commit $1 million (or by invitation from Montgomery Investment Management).

(continued from page 2)

a quarter, and Europe was worth another 10 per cent. As many other small-cap companies talk about offshore growth, Beyond has quietly built a strong international business.

It has also built a solid record. Return on equity (ROE) has risen from 10.3 per cent in FY04 to 26 per cent in FY13, with strong gains in the last three years. By small-cap standards, Beyond's ROE is high and surprisingly consistent for a company in the fickle global TV production market.

A strong balance sheet has underpinned growth. Beyond had no bank debt and $10.1 million in cash at the end of FY13. After paying $3.6 million in dividends, it has a significant funding surplus, meaning it does not have to raise debt capital or issue equity to fund growth.

'Beyond has some hallmarks of exceptional companies: consistently high and rising ROE, no debt, surplus cash flow and good management.'

Issued shares have increased from 59 million in FY04 to 61 million in FY13. Compared with many small-cap stocks that issue shares like confetti – and dilute existing shareholders – Beyond has been a scrooge with share issuance, which is important in driving ROE higher.

Taken together, Beyond has some hallmarks of exceptional companies: consistently high and rising ROE, no debt, surplus cash flow and good management. It is no surprise it is one of only 36 stocks with a cherished A1 rating from Montgomery for company performance and quality.

The market, of course, is well aware of Beyond's qualities. It has a one-year total shareholder return (including dividends) of 29 per cent, and over three years, the average annualised gain is 35 per cent. Over 10 years, Beyond has delivered an average 25 per cent return – remarkable by media standards.

After strong price gains, is there still a sufficient margin of safety to buy Beyond at current prices? Liquidity risk is significant: Beyond's top 20 shareholders owned about 86 per cent of its stock at the end of FY13, and annual stock turnover was only 13.4 per cent, according to Morningstar.

Low liquidity can be a boon when everything is going well, and good company news – such as last year's profit upgrade – drives the stock sharply higher. But it can be disastrous when investors need to sell quickly and an absence of buyers leads to large buy/sell spreads in the stock.

Low liquidity also makes it hard for small-cap fund managers to buy Beyond in sufficient quantity, or for stockbroking analysts to cover it. There are no consensus analyst forecasts for Beyond, and it is not a prolific publisher of company announcements, such as investor presentations.

Also, it has few comparable listed peers. The closest, Village Roadshow, has a significant film production business, but comes with theme parks and cinemas. Its $1.14 billion market capitalisation dwarfs Beyond's $92 million valuation.

Beyond's annual general meeting commentary, released in November, was characteristically brief and to the point. It said the TV production business continues to consolidate with *MythBusters*, *Selling Houses Australia*, *Deadly Women* and its new crime series, *Dark Temptations*.

The Beyond International film and TV distribution division is performing well, and the home entertainment business is benefiting from improving retail sentiment. The digital marketing business was expected to break even in the first half of FY14, thanks to restructuring efforts and client wins.

A recent statement from Beyond reported: "[We expected] strong sales in the international distribution business and improved retail support for the home entertainment division in the lead-up to Christmas. However, due to the timing of the production slate cycle across the second quarter, the company expects the revenues and net profit result for the six months to December 31, 2013 to be marginally behind that achieved for the corresponding period in 2012."

So the market expected a slightly weaker half-year result, year-on-year, when Beyond reported its interim profit on February 24. It delivered a 7.1 per cent fall in revenue to $46.3 million from the first-half of FY14, compared to the same period a year earlier. Net profit fell 5.9 per cent to $4.4 million.

Arguably, a weaker result than anticipated – about 10 per cent off Beyond's capitalisation after the result.

The home entertainment division had strong revenue growth, the distribution TV and film segment was flat, the digital market business performed below expectations, and

continued on page 5

(continued from page 4)

the critical TV production and copyright division had a 22 per cent revenue fall, mostly offset by lower costs.

Long-term, Beyond Productions' joint venture with Seven Network to create international programming will have little or no effect on the interim result, but is an excellent long-term strategic move. The deal, announced in October, will see 7Beyond create new programming, initially for North America.

Content from the venture will be co-produced by Seven Productions and Beyond Productions, and distributed internally by Beyond Distribution. Seven has a good record of content creation and Beyond has strong skills in developing programming for the US market.

Beyond rallied about 40 cents in October to a 52-week high of $2.10, only to give back most of those gains in the last few months, on low volume. We suspect the Seven deal is more significant than the market realises, as it allows Beyond to leverage Seven's programming success overseas.

This share-price fall has brought Beyond back to value territory. We estimate the company's FY14 intrinsic value to be $1.96, rising to $2.17 in FY15 and $2.41 a year later. Caution is needed due to the absence of consensus forecasts, but there is a good chance that Beyond will continue to lift ROE.

At $1.50, Beyond is trading at 23 per cent discount to our estimate of its current intrinsic value. It is not as cheap as it was a year or two ago, but a forecast double-digit percentage increase in intrinsic value in the next two years is a good sign.

A higher safety margin is required for less-liquid stocks, given the potential for share-price volatility, and market mavens could quibble that Beyond should provide more information to the market, such as detailed investor presentations.

Do we really need economists?

An insight into the relationship between the economy and your returns.

Not too long ago, when I was on set with Ticky Fullerton on the ABC's *The Business*, I was watching a piece put to air featuring an analyst talking about the effect of commodity prices and job losses on the pace of economic growth. The analyst concluded that investors should be cautious.

Linking the rate of economic growth to stock market returns is ubiquitous among investment practitioners and commentators. Not a day goes by that we don't see, hear or read a story about the economy with implications for investors.

But should you really care? Why is it that Warren Buffett and many others have never employed economists? Could the reason be that investor returns may not be influenced by how the economy is tracking?

In the below discussion I offer some insights into the relationship and arrive at a liberating discovery.

Let's suppose you employed someone to flip coins for you because you believed they were a 'lucky' flipper. Would you keep employing them, if after 34 years you found that they flipped winners only half the time? Anyone with a penchant for maths or an interest in Martingale may of course be quite satisfied, but the rest of the population would feel the lucky flipper was of little use at all.

And so we come to economists. With so much of business 'news' filled with commentary about the economy and analysis of it, I for one would certainly like to know whether any attention needs to be paid.

My friends Ashley Owen and Chris Cuffe published some interesting findings on Cuffelinks, regarding the relationship between stock market returns and the strength of the economy.

One of the unquestioned assumptions in our industry is that economic growth, or expectations of it, drives stock prices. One could certainly mount a reasonably convincing argument that economic growth drives company profits, which in turn, drives share prices.

Perhaps surprisingly, Ashley finds: "There is no statistical correlation between economic growth and stock market returns, either at a global level or in individual countries."

So there!

Ashley continues, commenting that "only rarely does above average world economic growth coincide with above average stock market returns. In only two of the past 34 years since 1980 has this been the case – 1988 and '06. Also, in only six years has below average economic growth coincided with below average stock market returns – '81, '90, '92, '01, '02 and '08.

In fact, at least half of the time when economic growth was above average, stock market returns were below average, and at least half of the time when economic growth was below average – including in recessions – stock market returns were above average."

So half the time, if the economy is strong, the stock market will be also, and half the time – it won't be.

Flip a coin!

So, it is wise to be listening to all the waffle about employment, interest rates, inflation and the like? Well, yes and no. You see, over the very long run there is a relationship, but it isn't between economic growth as measured by GDP and the stock market. There is, however, a relationship between interest rates combined with corporate profits and stock market returns.

Carol Loomis and Warren Buffett discussed this relationship in a 2001 edition of *Fortune* magazine.

Reaching the same conclusion as Ashley Owen, Buffett noted that between 1964 and '81, the stock market rose just one tenth of a per cent, and during the same period the economy expanded almost four-fold. Then, between

continued on page 8

(continued from page 6)

1981 and '98, when the economy grew by a more modest 177 per cent, the US stock market rose by ten-fold!

Here's an excerpt from the 2001 *Fortune* article:

> "The last time I tackled this subject, in 1999, I broke down the previous 34 years into two 17-year periods, which in the sense of lean years and fat were astonishingly symmetrical. Here's the first period. As you can see, over 17 years the Dow gained exactly one-tenth of one percent.
>
> Dow Jones Industrial Average
> - 31 December, 1964: 874.12
> - 31 December, 1981: 875.00
>
> And here's the second, marked by an incredible bull market that, as I laid out my thoughts, was about to end (though I didn't know that).
>
> Dow Jones Industrial Average
> - 31 December, 1981: 875.00
> - 31 December, 1998: 9181.43
>
> Now, you couldn't explain this remarkable divergence in markets by, say, differences in the growth of gross national product. In the first period – that dismal time for the market – GNP actually grew more than twice as fast as it did in the second period.
>
> Gain in Gross National Product
> - 1964-1981: 373%
> - 1981-1988: 177%
>
> So what was the explanation? I concluded that the market's contrasting moves were caused by extraordinary changes in two critical economic variables – and by a related psychological force that eventually came into play.

Here I need to remind you about the definition of "investing", which though simple is often forgotten. Investing is laying out money today to receive more money tomorrow.

That gets to the first of the economic variables that affected stock prices in the two periods – interest rates. In economics, interest rates act as gravity behaves in the physical world. At all times, in all markets, in all parts of the world, the tiniest change in rates changes the value of every financial asset. You see that clearly with the fluctuating prices of bonds. But the rule applies as well to farmland, oil reserves, stocks, and every other financial asset. And the effects can be huge on values. If interest rates are, say, 13 per cent, the present value of a dollar that you're going to receive in the future from an investment, is not nearly as high as the present value of a dollar if rates are 4 per cent.

So here's the record on interest rates at key dates in our 34-year span. They moved dramatically up – that was bad for investors –in the first half of that period, and dramatically down – a boon for investors – in the second half.

Interest rates, Long-term government bonds
- Dec. 31, 1964: 4.20%
- Dec. 31, 1981: 13.65%
- Dec. 31, 1998: 5.09%

The other critical variable here is how many dollars investors expected to get from the companies in which they invested. During the first period, expectations fell significantly because corporate profits weren't looking good. By the early 1980s, Fed Chairman Paul Volcker's economic sledgehammer had, in fact, driven corporate profitability to a level that people hadn't seen since the 1930s.

The upshot is that investors lost their confidence in the American economy: They were looking at a future they believed would be plagued by two negatives. First, they didn't see much good coming in the way of corporate profits. Second, the sky-high interest rates prevailing caused them to discount those meager profits further. These two factors, working together, caused stagnation in the stock market from 1964 to '81, even though those years featured huge improvements in GNP. The business of the country grew while investors' valuation of that business shrank!"

continued on page 10

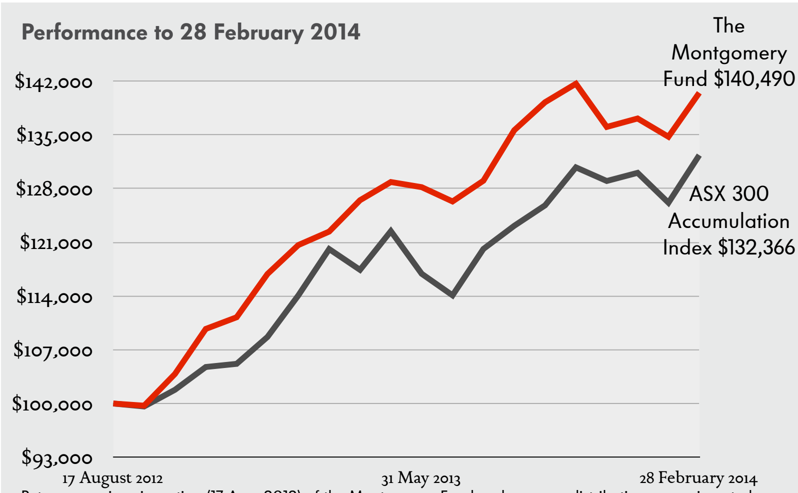
WELCOME TO THE BOUTIQUE INVESTMENT MANAGEMENT OFFICE OF MONTGOMERY

The Montgomery Fund has outperformed materially since inception.

How?

We don't change course or switch boats half-way across the stream, and The Montgomery Fund invests in the safety of cash when the market appears expensive.

No time to invest yourself?
Too much information to process?
Invest in The Montgomery Fund – high quality businesses purchased at rational prices.



Returns are since inception (17 Aug, 2012) of the Montgomery Fund and assumes distributions are reinvested.
Past performance is not indicative of future performance.

Minimum investment $25,000

MONTGOMERY

Click here to find out more

Investment Manager Montgomery Investment Management Pty Ltd | ABN 73 139 161 701 | AFSL 354 564 | GPO Box 3324 Sydney NSW 2001 | 02 8046 5000 | www.montinvest.com | office@montinvest.com Trustee Fundhost Limited | ABN 69 092 517 087 | AFSL 233 045 * 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 Investment Management Pty Ltd, AFSL No: 354564 ("Montgomery") the investment manager of The Montgomery Fund. The Responsible Entity of the Fund is Fundhost Limited (ABN 69 092 517 087) (AFSL No: 233 045) ("Fundhost"). This document has been prepared for the purpose of providing general information, without taking account your particular objectives, financial circumstances or needs. You should obtain and consider a copy of the Product Disclosure Statement ("PDS") relating to the Fund before making a decision to invest. While the information in this document has been prepared with all reasonable care, neither Fundhost nor Montgomery makes any representation or warranty as to the accuracy or completeness of any statement in this document including any forecasts. Neither Fundhost nor Montgomery guarantees the performance of the Fund or the repayment of any investor's capital. To the extent permitted by law, neither Fundhost nor Montgomery, including their employees, consultants, advisers, officers or authorised representatives, are liable for any loss or damage arising as a result of reliance placed on the contents of this report. Past performance is not indicative of future performance.

(continued from page 8)

So what should we do about all the economic noise filling the airwaves, the papers and investment newsletters?

Simply have a look at the long-term trends for interest rates and then ask whether they are generally going to trend lower or higher over the next five to ten years.

Secondly, ask whether profits, as a proportion of the economy, are trending higher or lower.

Buying big, so-called “blue chips”, and shoving them in the bottom drawer on the back of the mistaken belief that it’s “time in the market” that covers a multitude of sins, will be a mistake.

Being a nimble investor, willing to focus selectively on the very highest quality companies and the very best value, and being willing to sell and raise cash when stock prices reflect irrational exuberance, will be important in the next five to ten years. And it will be more important than knowing what the economy is going to do next week, next month or even next year.

IMPORTANT NOTICE

This document has been prepared by Montgomery Investment Management Pty Ltd.

The issuer of units in The Montgomery Fund (Retail Fund) is the Retail Fund's responsible entity Fundhost Limited (ABN 69 092 517 087). The Product Disclosure Statement for the Retail Fund contains all of the details of the offer. Copies of the Product Disclosure Statement are available from Montgomery Investment Management (02) 9692 5700 or at www.montinvest.com. An investment in the Retail Fund will only be available through a valid application form attached to the Product Disclosure Statement. Before making any decision to make or hold any investment in the Retail Fund you should consider the Product Disclosure Statement in full.

The issuer of units in The Montgomery [Private] Fund (Private Fund) is the Private Fund's trustee Fundhost Limited (ABN 69 092 517 087). The Information Memorandum for the Private Fund contains all of the details of the offer. Copies of the Information Memorandum are available from Montgomery Investment Management (02) 9692 5700 or at www.montinvest.com. An investment in the Private Fund will only be available through a valid application form attached to the Information Memorandum. Before making any decision to make or hold any investment in the Private Fund you should consider the Information Memorandum in full.

The information provided does not take into account the 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 if necessary.

Future investment performance can vary from past performance. You should not base an investment decision simply on past performance. Past performance is not an indicator of future performance. The investment returns of the Retail Fund and the Private Fund are not guaranteed, the value of an investment may rise or fall.

This document is based on information obtained from sources believed to be reliable as at the time of compilation. However, no warranty is made as to the accuracy, reliability or completeness of this information. Recipients should not regard this document as a substitute for the exercise of their own judgement or for seeking specific financial and investment advice. Any opinions expressed in this document are subject to change without notice and MIM is not under any obligation to update or keep current the information contained in this document.

To the maximum extent permitted by law, neither MIM nor any of its related bodies corporate nor any of their respective directors, officers and agents accepts any liability or responsibility whatsoever for any direct or indirect loss or damage of any kind which may be suffered by any recipient through relying on anything contained in or omitted from this document or otherwise arising out of their use of all or any part of the information contained in this document. Additional information will be made available upon request.