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Inside The Montgomery Fund Returns

Whitepaper by Scott Phillips, Head of Distribution

The Montgomery Fund has produced after-fees returns superior to the market, and it has also provided other benefits. Investors require not only superior performance, they also demand a superior pattern of returns than those offered by the deservedly-cheaper index funds. Since inception, The Montgomery Fund, has provided investors with the benefits of the upside, but less of the downside.

As we extend the successful track record of The Montgomery Fund, we are able to offer meaningful observations about its behavior and demonstrate its characteristics, allowing investors, advisers and investment consultants to assess the merits and the role the Fund can play as an Australian equity investment.

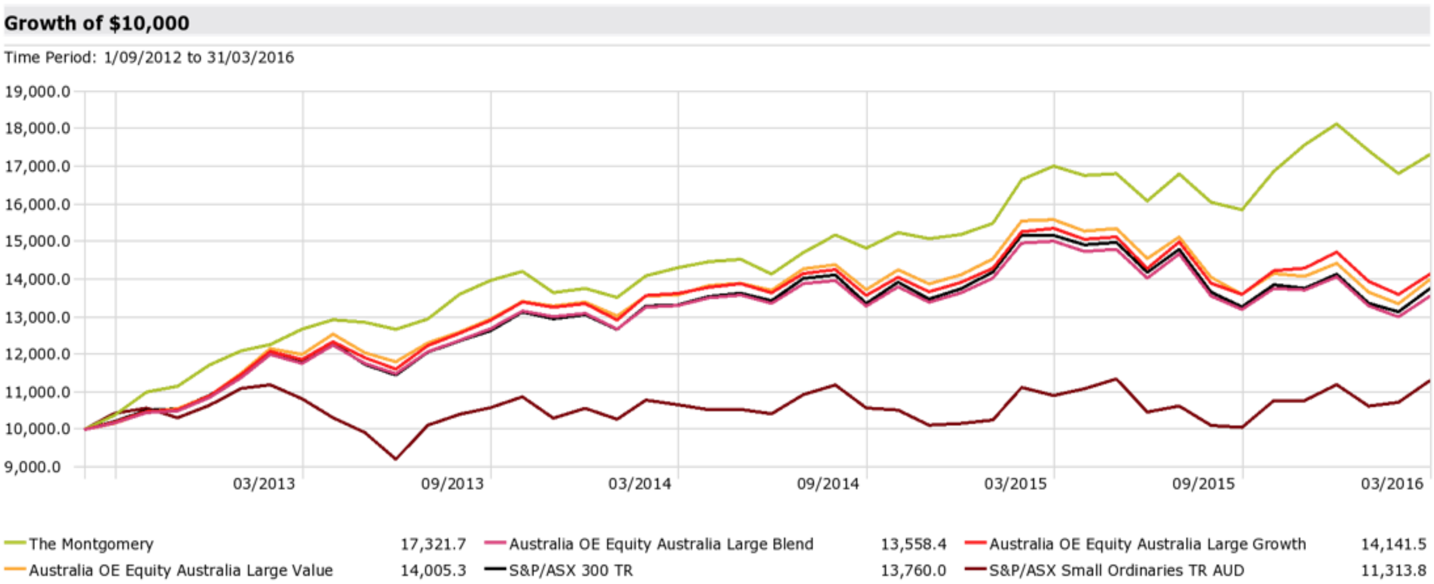
For analysis purposes I have used the Morningstar Direct tool to compare The Montgomery Fund against three other categories of managers in the Australian equity marketplace. The three categories are:

- Australia OE (Open Ended) Equity Australia Large Blend
- Australia OE (Open Ended) Equity Australia Large Growth
- Australia OE (Open Ended) Equity Australia Large Value

Managers in these categories typically adopt the S&P/ASX 300 TR (Total Return) index as their benchmark. I have also added the S&P/ASX Small Ordinaries TR index for comparison purposes. Both indexes assume reinvestment of dividends.

The time frame used starts from the first full month of operation of The Montgomery Fund (1 September 2012) until the most recent full month (31 March 2016). All returns are net of expenses, apart from index returns.

Figure 1.



Performance

Time Period: 1/09/2012 to 31/03/2016

	Return	Cumulative Return	Standard Deviation	Excess Return	Information Ratio (arith)	Sharpe Ratio (arith)	Tracking Error
The Montgomery	16.57	73.22	10.63	7.25	0.98	0.74	7.41
Australia OE Equity Australia Large Blend	9.03	36.30	11.90	-0.29	-0.32	0.03	0.91
Australia OE Equity Australia Large Growth	10.17	41.49	11.93	0.85	0.54	0.13	1.58
Australia OE Equity Australia Large Value	9.92	40.36	11.73	0.61	0.41	0.11	1.48
S&P/ASX 300 TR	9.32	37.60	12.36	0.00		0.05	0.00
S&P/ASX Small Ordinaries TR AUD	3.50	13.14	14.16	-5.81	-0.65	-0.36	8.97

Figure 1. considers the growth of a $10,000 investment made in The Montgomery Fund compared to the other categories of Australian equity managers, the S&P/ASX 300 and S&P/ASX Small Ordinaries indices, with all distributions and dividends, respectively, reinvested. Over this three and a half year period, The Montgomery Fund has generated a 16.57 per cent return per annum against the benchmark return of 9.32 per cent per annum thus generating "excess return" of **7.25** per cent per annum.

Considerably better than any of the other categories of Australian equity managers, The Montgomery Fund has also produced a cumulative return of 73.22 per cent, against the index return of 37.60 per cent. And remember, this is after all expenses.

Interestingly, Australian smaller companies, as represented by the S&P/ASX Small Ordinaries TR index, have significantly underperformed the large cap peer index by 5.81 per cent per annum, resulting in a cumulative return of just 13.14 per cent over the three and a half year period under review.

Risk-Reward

We know that The Montgomery Fund has out-performed both the indices and the other Australian equity large cap categories but what was the experience for investors? Was the out-performance delivered with more volatility in the monthly returns throughout its history? Clients are particularly sensitive to the pattern of returns and the path taken to achieve them.

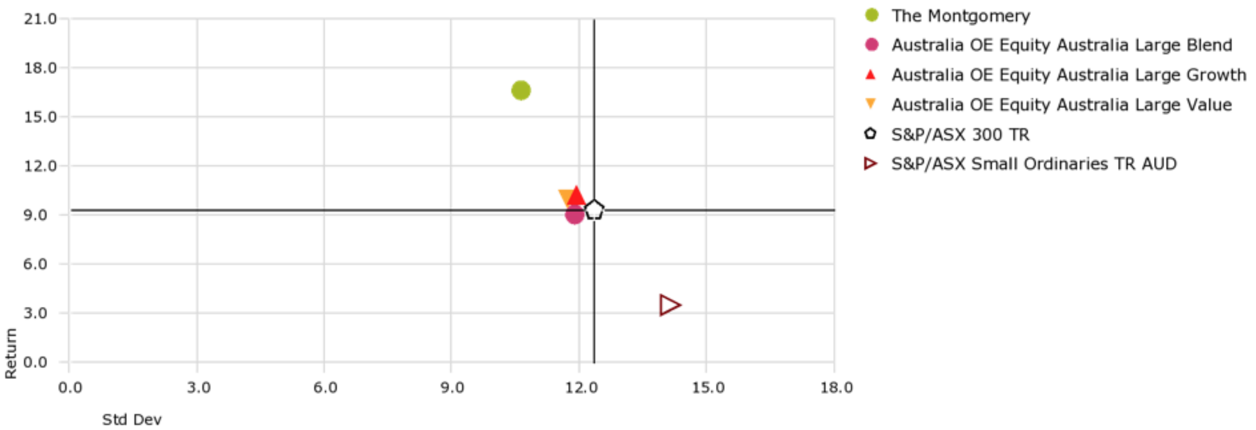
Figure 2. plots the per annum return (Reward) vs. the monthly standard deviation of these returns (volatility as a measure of risk). As illustrated by Figure 2., The Montgomery Fund is designated by the green circle situated in the upper-left hand quadrant of the chart. It's position indicates the Fund not only out-performed the other categories of Australian equity managers - and the benchmark - but also achieved this with a lower standard deviation of returns (Risk).

Figure 2.

Risk-Reward

Time Period: 1/09/2012 to 31/03/2016

Peer Group (5-95%): Open End Funds - Australia - Equity Australia Mid/Small Growth



Risk

Time Period: 1/09/2012 to 31/03/2016

	Return	Std Dev	Downside Deviation	Alpha	Beta	R2	Sharpe Ratio (arith)	Tracking Error
The Montgomery	16.57	10.63	4.08	6.42	0.84	84.46	0.74	7.41
Australia OE Equity Australia Large Blend	9.03	11.90	0.66	-0.30	0.97	99.83	0.03	0.91
Australia OE Equity Australia Large Growth	10.17	11.93	0.96	0.76	0.97	99.36	0.13	1.58
Australia OE Equity Australia Large Value	9.92	11.73	0.96	0.51	0.97	99.46	0.11	1.48
S&P/ASX 300 TR	9.32	12.36	0.00	0.00	1.00	100.00	0.05	0.00
S&P/ASX Small Ordinaries TR AUD	3.50	14.16	7.66	-5.26	0.99	81.19	-0.36	8.97
25th Percentile	16.47	14.36	6.77	6.70	1.01	87.54	0.51	9.18
50th Percentile	12.77	13.01	5.08	3.24	0.94	83.54	0.30	7.87
75th Percentile	10.93	12.30	3.89	1.52	0.87	79.08	0.17	6.78

Upside-Downside Capture

It is no great surprise that investors are a discerning bunch. They demand their active equity managers performance "goes up when everyone else is going up, but not go down as much when everyone else is going down." In its relatively short life, since inception, The Montgomery Fund has been able to deliver this outcome for its investors.

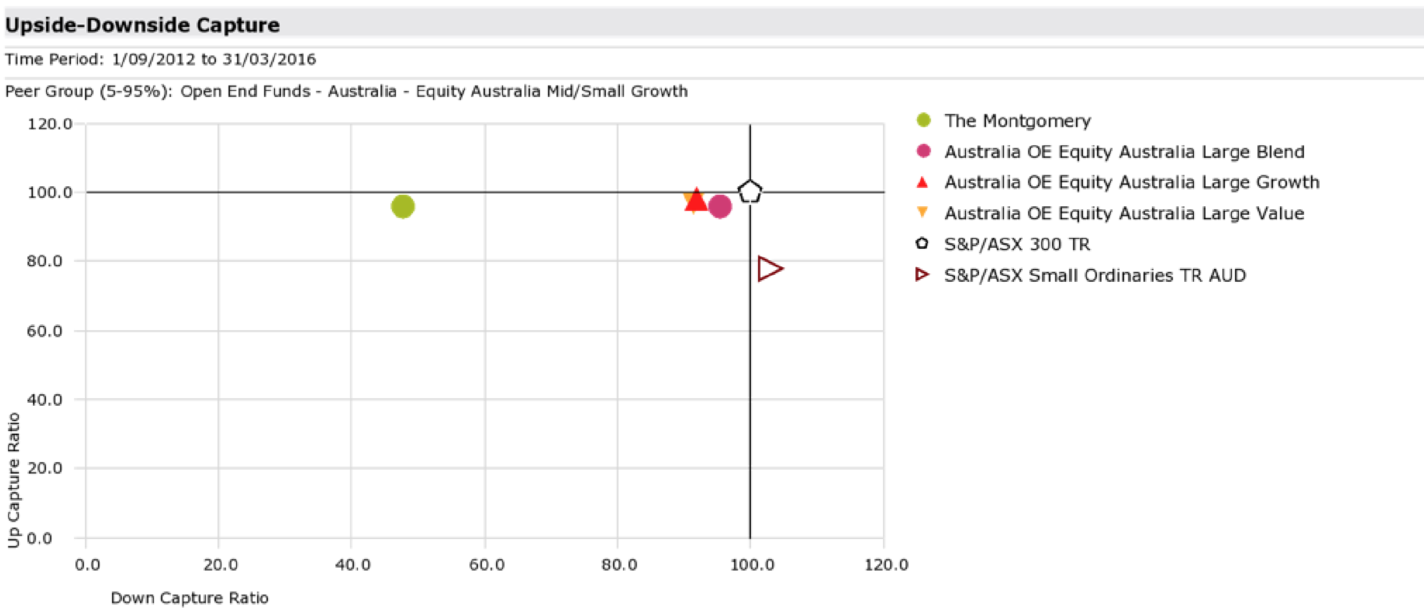
Figure 3. plots the "Up Capture Ratio vs. Down Capture Ratio" for each investment. The Up Capture Ratio tells us from the past returns of the investment when the S&P/ASX 300 TR index delivered a positive monthly return, the percentage of that positive move the investment generated.

The Montgomery Fund's pattern of returns have produced an Up Capture Ratio of 95.83 per cent. This means that on average, when the S&P/ASX 300 TR index is positive, the Fund returned 95.83 per cent of the positive return. In other words, a 2 per cent positive move by the market in a month, saw The Montgomery Fund gain returns of 1.91 per cent (2 per cent x 95.83 per cent).

Similarly, the Down Capture ratio measures the percentage movement in the investment when compared to a negative monthly return from the S&P/ASX 300 TR index. The Montgomery Fund has produced a Down Capture Ratio of 47.76 per cent. Inferring that when markets are negative, the Fund only experienced 47.76 per cent of the negative market movement.

While the past pattern of returns might not be a reliable guide to the future pattern of returns, the Montgomery investment team of nine are obviously pleased to be have been able to deliver strong gains when the market is positive and limited downside exposure when the market returns negative. The reasons can be attributed to a focus on the securities of high quality business names and a repeatable process of increasing the cash weighting when satisfactory opportunities are unavailable.

Figure 3.



This compares favourably to any of the Australian equity categories of Growth, Value or Blend where each categories Upside capture might be slightly higher but their Downside capture is far less palatable for investors, given they are capturing between 90 per cent and 95 per cent of the negative returns from the Australian Equity market.

Correlation Matrix

For those investors, advisers or consultants using more than one manager for their Australian equity exposure, reviewing the return correlation between managers is one useful measure to consider. Correlation is a statistical measure of how two securities (funds, assets or indices) move in relation to each other .

Table 1. considers the correlation between The Montgomery Fund, three categories of Australian Equity managers being Blend, Growth and Value style managers and finally the broad index (S&P/ASX 300 TR). What we can observe from these various correlations is that there is almost a perfect correlation between the broad index and each category of large cap Australian Equity managers, given each category's correlation to the index is either 1.00 or 0.99 . There is little to no diversification benefit attained by blending these assets together. On the other hand, when we review the correlations between each of these manager style categories or the broad index against The Montgomery Fund, we achieve a much lower correlation of between 0.80 and 0.84, meaning that the assets move in a much less correlated way. This is because The Montgomery Fund does not look or act the same as the index or these other style categories and as we have noted previously, the Fund tends not to go down as much when the market is negative. As a result, there would be diversification benefits garnered by the addition of The Montgomery Fund to any of these other categories of Australian managers or the broad index itself.

Table 1.

Correlation Matrix

Time Period: 1/09/2012 to 31/03/2016

		1	2	3	4	5	6
1	The Montgomery	1.00					
2	Australia OE Equity Australia Large Blend	0.81	1.00				
3	Australia OE Equity Australia Large Growth	0.84	1.00	1.00			
4	Australia OE Equity Australia Large Value	0.81	1.00	0.99	1.00		
5	S&P/ASX 300 TR	0.80	1.00	0.99	0.99	1.00	
6	S&P/ASX Small Ordinaries TR AUD	0.71	0.77	0.78	0.74	0.78	1.00

1.00 to 0.80 | 0.80 to 0.60 | 0.60 to 0.40 | 0.40 to 0.20 | 0.20 to 0.00
0.00 to -0.20 | -0.20 to -0.40 | -0.40 to -0.60 | -0.60 to -0.80 | -0.80 to -1.00

Since we know The Montgomery Fund has out-performed all categories of Australian equity managers as well as the broader index, then its addition to any of these assets has, to date, produced the dual benefit of improved diversification and superior returns.

Holdings-Based Style Map

Morningstar categorises all stocks listed on the Australian Securities Exchange by both market capitalisation (Giant to Micro) on the Y-axis, and style characteristic (Deep-Value to High Growth) on the X-axis. Figure 4. plots where the average holding of each portfolio or category resides (solid central point of each oblique). The shaded oblique around the central point represents the "Ownership Zone" for each portfolio and represents the best fit for 75 per cent of their holdings.

Figure 4.

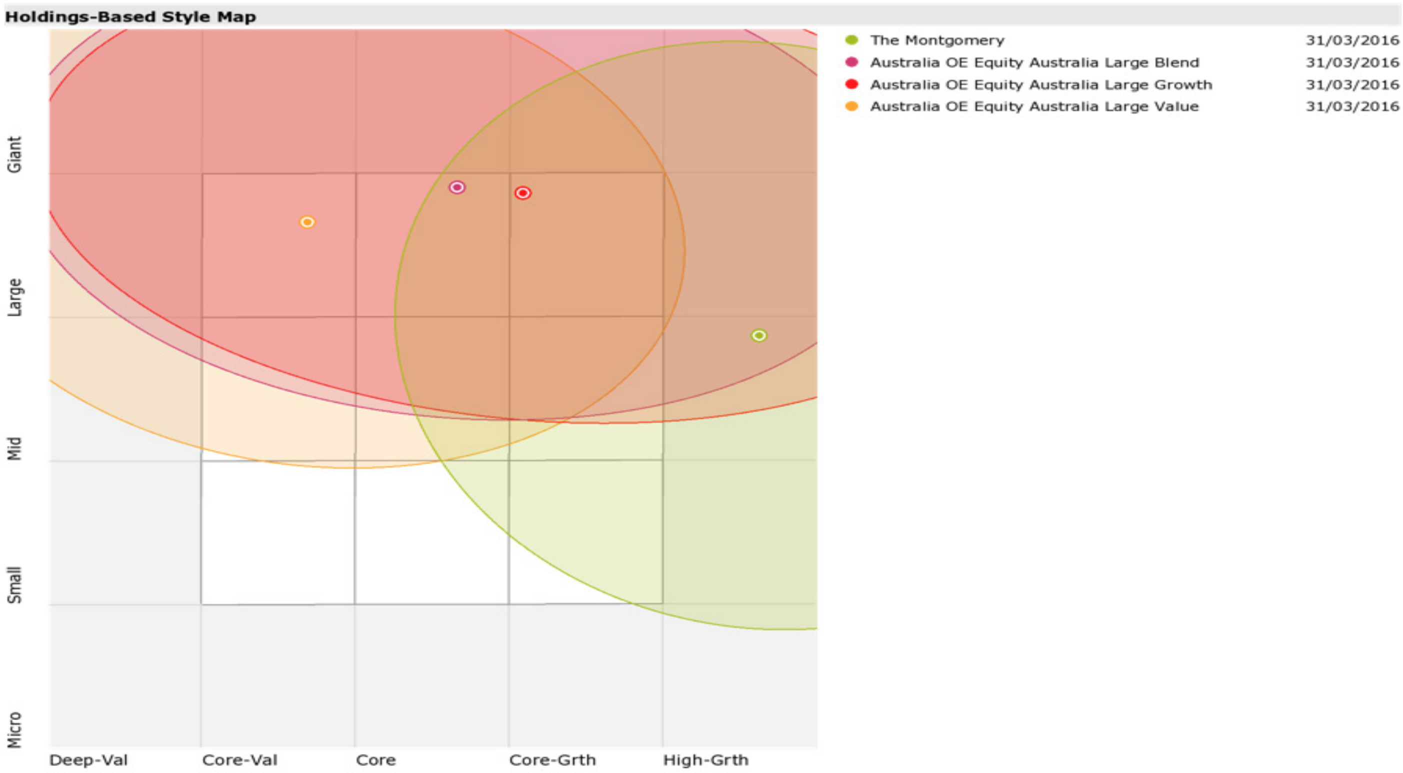


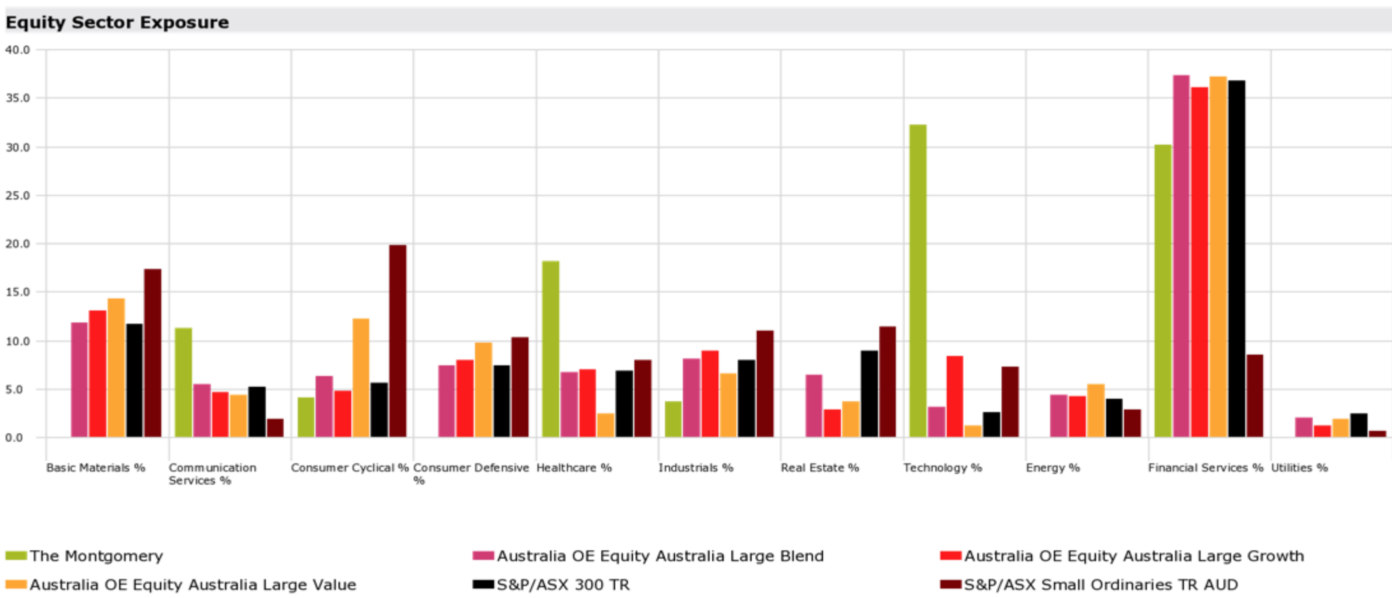
Figure 4. reveals that all categories of Australian Equities managers (Value, Blend and Growth) have similar average capitalisation biases leaning towards the Giant and Large Cap space. The Montgomery Fund on the other hand has a smaller average capitalisation bias and spans Small, Mid, Large and some Giant Capitalisation companies. This is consistent with the strategy of The Montgomery Fund to uncover the very best companies, which fulfill the strict Montgomery investment criteria. Montgomery believes Blue Chip companies don't always have to be large by capitalisation and conversely many large capitalisation companies are certainly not "Blue Chips".

Equity Sector Exposure

Finally, Figure 5. takes a snapshot of the equity sector exposures in each portfolio or category and compares those snapshots against both the broader index - the S&P/ASX 300 TR - and each other to enable a quick reconciliation of the differences.

In particular, sector positions as at 31 March 2016 reveal The Montgomery Fund is very active compared to both the index and the other categories of Australian Equity Managers, resulting in a high conviction, benchmark unaware exposure. This is consistent with the philosophy of The Montgomery Fund, which only invests in companies that are of high quality, demonstrate bright prospects and can be bought at a reasonable price. At the moment there are many companies and sectors that are not represented in the Fund.

Figure 5.



Most notably The Montgomery Fund has:

- No exposure to Basic Materials, Consumer Defensive, Real Estate, Energy or Utilities sectors
- Significant exposure to Communication Services, Healthcare, Technology and Financial Services

In conclusion, The Montgomery Fund over its relatively short history has demonstrated a number of key characteristics that has made it a worthy portfolio holding. In particular, the Fund has significantly outperformed the broader Australian equity market, achieving this with less risk, more downside protection in weak markets, while having some flexibility to sit in the safety of cash if valuations become demanding.