For What It's Worth

A Montgomery White Paper
DECEMBER 2013

Tech Stocks: Seduction or Sound Value?

Outside the soaring newcomers, IRESS is also beyond fair value but it has a solid record and outlook.

By Roger Montgomery

When newspapers refer to a "frenzy" in tech stocks and breathtakingly report on the latest tech wunderkind, you know it is time to block out even more market noise and strictly focus on company valuations. Being seduced by hype is a surefire way to burn money.

Remember the crazy valuations for tech stocks in the late 1990s and the insane spruiking that accompanied them? The latest boom is arguably a year – maybe two – from those heady days, and some new tech stars have substance and terrific long term prospects. But an expected rush of tech floats, soaring valuations, and over-zealous promoters are never good signs.

The emerging accounting software provider, Xero, is an example. One investment bank recently dubbed it the "Apple of Accounting" and suggested it could become a $10 billion tech stock within five years, listed on the US Nasdaq Exchange. After its shares soared sixfold this year, Xero is capitalised at $3.85 billion, or about 13 times the size of its well established, profitable rival, Reckon, and at least three times the size of MYOB, based on its acquisition price in 2011.

Xero has a big price tag for a loss-making company that has about a 4 per cent share of the small business market for accounting services in Australia. Undoubtedly, Xero has a lucrative position as accounting software moves from a desktop product paid for upfront to a monthly service via cloud computing. But its valuation is factoring in incredible growth in market share and revenue.

Freelancer is another highly valued tech stock. The internet float soared from a 50 cent issue price in November to as high as $2.60, before easing to $1.33, for a $573 million valuation. It has a terrific position in the global micro-jobs sourcing market, a highly scalable business model, and forecast gross margins of 88 per cent. Even so, value investors would need a compelling reason to pay $573 million for a company forecast to earn $471,000 in FY13.

Xero, Freelancer and other fast-growth tech stocks might head higher for the balance of this year or next, such is the current fervour. But chasing loss-making companies with nose-bleeding valuations is speculation, not value investing. These valuations have no room for even the slightest disappointments in revenue or customer growth.

To put these prices in perspective, Xero's valuation is more than twice that of IRESS, one of the highest quality ASX listed mid-cap stocks and a terrific long term performer. IRESS, too, looks overvalued after strong price gains this year, but has a lot more substance than most tech stocks.

IRESS provides financial markets information and wealth management services to finance industries in Australia, New Zealand, South Africa, Asia and, increasingly, the United Kingdom. Chances are your full-service broker uses an IRESS terminal for sharemarket information.

The business excels on several fronts. Wealth management technology, once embedded in organisations, is highly "sticky" and has high switching costs to change vendors. These attributes, and the capital investment required to develop the technology, create barriers for new entrants.

Being seduced by hype is a surefire way to burn money

IRESS technology provides recurring, annuity-like income as financial professionals automatically re-subscribe for the information and wealth management services each year. Dependency on these services gives IRESS some degree of pricing power and earnings visibility.

Another attraction is scalability. IRESS has done a good job taking its intellectual property to other markets, without loading on debt or issuing highly discounted equity capital raisings that dilute existing shareholders.

The ability to grow globally is just as important. Almost 20 per cent of IRESS revenue comes from outside Australia and New Zealand, a proportion that should grow rapidly since the acquisition in September 2013 of Avelo, a leading financial technology provider in the UK.

These attributes invariably create a high quality company. IRESS is one of only 29 ASX-listed companies with the cherished A1 Montgomery quality rating. IRESS has been A-rated since 2004 and received the highest performance rating in seven of the past ten years.

Its return on equity (ROE) has hovered above 30 per cent for the past decade, debt is low, and operational cash flow has grown strongly. IRESS had no debt until the Avelo acquisition was funded, partly by the issue of $170 million in new debt, which is conservative. Net debt will be $111 million after surplus cash is also used to fund the Avelo deal. The IRESS balance sheet has scope for further acquisitions.

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 30 November 2013

Code		Change	Outperfomance
MPF	**The Montgomery [Private] Fund**	**39.17%**	**-**
XNAJI	ASX 200 Industrials Accumulation Index	15.32%	23.85%
XTOAI	ASX 100 Accumulation Index	30.04%	9.13%
XJOAI	ASX 200 Accumulation Index	26.86%	12.31%
XAOAI	All Ordinaries Accumulation Index	23.74%	15.43%
XKOAI	ASX 300 Accumulation Index	25.20%	13.97%
XTLAI	ASX 20 Accumulation Index	35.29%	3.88%
XMDAI	ASX Midcap 50 Accumulation Index	7.39%	31.78%
XSOAI	ASX Small Ordinaries Accumulation Index	-18.06%	57.23%

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 I ABN 73 139 161 701 I AFSL 354 564 I GPO Box 3324 Sydney NSW 2001 I 02 9692 5700 I www.montinvest.com I office@montinvest.com Trustee Fundhost Limited I ABN 69 092 517 087 I 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).

IRESS's quality is well known to the market. It has an annualised average total shareholder return (including dividend investment) of 20 per cent over 10 years – an excellent result given sharemarket volatility during that time. Over one year to 28 November 2013, IRESS had returned 28 per cent, after strong price gains in the second half of the year. Not even the 2008 GFC, which dented demand for market information data screens, could stop IRESS's long term gains.

Has the market got ahead of itself with IRESS, as has been the case with so many other tech stocks this year?

But has the market got ahead of itself with IRESS, as has been the case with so many other tech stocks this year? IRESS's ROE, almost 31 per cent in FY12, fell to 24 per cent for the interim FY13 result and is expected to hover around 20 per cent for the next two years, based on the consensus of nine analyst earnings forecasts.

Declining ROE is never a good sign. After comfortably exceeding 40 per cent between 2003 and 2006, IRESS's ROE has drifted lower, despite total shareholder equity remaining fairly constant until FY12. Declining ROE is often a precursor for declining intrinsic value and a lower share price.

Montgomery Investment Management values IRESS at around $8.50 per share. Compared to a $9.83 share price, IRESS is about 15 per cent overvalued.

IRESS traded around $6 at its 2012 low and just above $7 in July 2013. Then it raced to as high as $10.38 as investors became more bullish about the wealth management industry's prospects.

Although IRESS has recurring revenue, demand for its information services is affected by the cyclicality of the wealth management industry. A rising sharemarket over 12 months and more fund managers finally having positive net fund inflows has boosted wealth management stocks. Combined with its UK deal, IRESS has quickly returned to market darling status.

The Avelo acquisition looks like a good long term move. It gives IRESS a strong footprint in the financial services technology market in the UK, and is expected to be more than 10 per cent earnings-per-share accretive in 2014. Regulatory change in the UK financial services industry has created an opportunity for IRESS, by boosting demand for technology that helps investment providers with reporting and compliance.

IRESS has scope for stronger long term growth in the UK, South Africa and Asia as it rolls out its technology platform or potentially acquires businesses. But there is a threat of rising competition for market data and from specialist wealth management technology providers.

On balance, IRESS has some powerful tailwinds in the coming decade: continued mandated growth in wealth management industries as Australian and overseas investors contribute more to their retirement savings; potential to enter fragmented offshore markets, many of which are a long way behind Australia in terms of financial services regulation, compliance and disclosure; and continued regulatory change and higher demand for technology reporting services.

Combined with a high-quality company, an excellent business model, and a strong management team, IRESS has a platform for long term sustained earnings growth and share price gains. But unless there is a significant change in its earnings outlook, IRESS is overvalued on a short-term view.

Even so, IRESS is not nearly as overvalued as sexier technology companies that have seduced the sharemarket with their global growth aspirations, scalable business models, and rampant insurgency in established industries. IRESS, at least, is an exceptional company over a long period, as determined by profits and performance, not potential or promise.

The challenge is buying IRESS at a bargain price – rare in companies of its quality – or at least closer to fair value.

The Montgomery team wishes you a wonderful Christmas and new year. We look forward to sharing our next subscriber-only white paper with you in 2014.

WELCOME TO THE BOUTIQUE INVESTMENT MANAGEMENT OFFICE OF MONTGOMERY

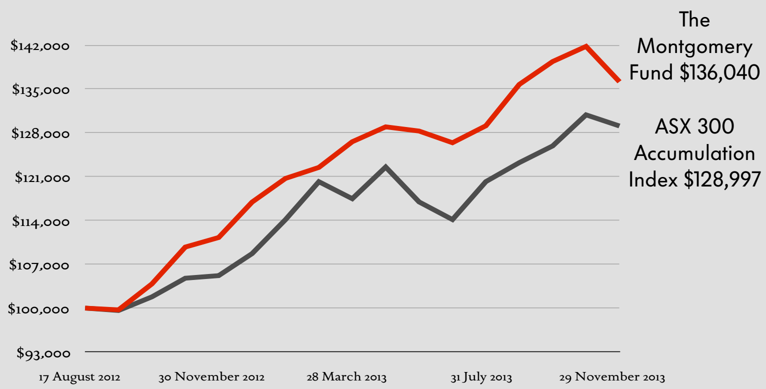
The Montgomery Fund has outperformed materially since inception.

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.

Performance to 30 November 2013



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 9692 5700 | 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.

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.